

FEDERAL RESERVE BANK GOVERNANCE AND INDEPENDENCE DURING FINANCIAL CRISIS

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Federal Reserve Bank Governance and Independence during Financial Crisis¹

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PREFACE AND ACKNOWLEDGMENTS

This is the third report in a series examining the Federal Reserve Bank's response to the global financial crisis, with particular emphasis on questions of accountability, democratic governance and transparency, and mission consistency.

In our 2012 report, "Improving Governance of the Government Safety Net in Financial Crisis," we explored alternative methods of providing a government safety net in times of crisis. In the present crisis, the United States used two primary methods: a stimulus package approved and budgeted by Congress, and a complex and huge bailout by the Federal Reserve with assistance from the Treasury. In that report, we documented that the Fed originated well over \$29 trillion in loans made to financial institutions in its "alphabet soup" of special facilities. Most of the bailout took place behind closed doors, and much of it took the form of "deal making."

In our 2013 report, "The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention after 2007," we focused on the role played by the Fed as "lender of last resort" in the aftermath of the financial crisis. For more than a century and a half it had been recognized that a central bank *must* act as lender of last resort in a crisis. A body of thought to guide practice had been well established over that period, and central banks have used those guidelines many, many times to deal with countless financial crises around the globe.

As we explained, however, the Fed's intervention from 2008 stands out for three reasons: the sheer size of its intervention, the duration of its intervention, and its deviation from standard practice in terms of interest rates charged and collateral required against loans. We examined the implications of the tremendous overhang of excess reserves, created first by the lender-of-last-resort activity, but then greatly expanded in the Fed's series of quantitative easing programs. After that, we turned to a detailed exposition of the Fed's lending activity, focusing on the very low interest rates charged—which could be seen as a subsidy to borrowing banks. We concluded by examining how the reforms enacted after the crisis might impact the Fed's autonomy in governing the financial sector and in responding to the next crisis.

In this year's report, we focus on issues of central bank independence and governance, with particular attention paid to challenges raised during periods of crisis. We trace the principal changes in governance of the Fed over its history—changes that accelerate during times of economic stress. We pay special attention to the famous 1951 "Accord" and to the growing consensus in recent years for substantial independence of the central bank from the treasury. In some respects, we deviate from conventional wisdom, arguing that the concept of independence is not usually well defined. While the Fed is substantially independent of day-to-day politics, it is not operationally independent of the Treasury. We examine in some detail an alternative view of monetary and fiscal operations. We conclude

that the inexorable expansion of the Fed's power and influence raises important questions concerning democratic governance that need to be resolved.

Our final report will be issued in April 2015. That report will summarize our findings and will make concrete policy recommendations concerning the following issues:

1. Is there an operational difference between commitments made by the Fed and those made by the Treasury? What are the linkages between the Fed's balance sheet and the Treasury's? This year's report examines those linkages in detail.
2. Are there conflicts between the Fed's responsibility for normal monetary policy operations and the need to operate a government safety net to deal with severe systemic crises?
3. How much transparency and accountability should the Fed's operations be exposed to? Are different levels of transparency and accountability appropriate for different kinds of operations—for example, formulation of interest rate policy, oversight and regulation, resolving individual institutions, and rescuing an entire industry during a financial crisis?
4. Should safety-net operations during a crisis be subject to normal congressional oversight and budgeting? Should such operations be on- or off-budget? Should extensions of government guarantees (whether by the Fed or by the Treasury) be subject to congressional approval?
5. Is there any practical difference between Fed liabilities (bank notes and reserves) and Treasury liabilities (coins and bonds or bills)? If the Fed spends by "keystrokes" (crediting balance sheets, as former chairman Ben Bernanke said), can—or does—the Treasury spend in the same manner? That topic is also examined in some detail here.
6. Is there a limit to the Fed's ability to spend, lend, or guarantee? Is there a limit to the Treasury's ability to spend, lend, or guarantee? If so, what are those limits? And what are the consequences of increasing Fed and Treasury liabilities?
7. What can we learn from the successful resolution of the 1930s crisis and the thrift crisis that could be applicable to the current crisis? What can we learn from successful crisis resolutions in other nations? Going forward, is there a better way to handle resolutions, putting in place a template for a government safety net to deal with systemic crises when they occur? (Note that this is a separate question from creation of a systemic regulator to attempt to prevent crises from occurring; however, we will explore the wisdom of separating the operation of the safety net from the operations of a systemic regulator.)
8. What should be the main focuses of the government's safety net? Possibilities include rescuing and preserving financial institutions versus resolving them, encouraging private lending versus direct spending to create aggregate demand and jobs, debt relief versus protection of interests of financial institutions, and minimizing budgetary costs to government versus minimizing private or social costs.

9. Does Fed intervention create a burden on future generations? Does Treasury funding create a burden on future generations? Is there an advantage of one type of funding over the other?

10. Is it possible to successfully resolve a financial crisis given the structure of today's financial system? Or, is it necessary to reform finance first in order to make it possible to mount a successful resolution process?

A major goal of the project is to provide a clear and unbiased analysis of the issues involved, and a series of proposals on how the Federal Reserve can be reformed to provide more effective governance and more effective integration with Treasury operations and fiscal policy governance through Congress. These are the issues that drive our investigation. This report makes a contribution toward enhancing our understanding of several of these topics enumerated above. Our final report in 2015 will tackle the most difficult issue: how to reform the Fed.

The Federal Reserve is now 100 years old. Over the past century, the Fed's power has grown considerably. In some respects, the Fed's role has evolved, but in other ways it is showing its age. In the introduction to this year's report, William Greider—author of *Secrets of the Temple: How the Federal Reserve Runs the Country*—argues that it is time for an overhaul. The Fed was conceived in crisis—the crisis of 1907—as the savior of a flawed banking system. If anything, the banking system we have today is even more troubling than the one that flopped in 1907, and that crashed again in 1929. There were major reforms of that system in the New Deal, and some reforms were also made to the Fed at that time. By the standard of the Roosevelt administration's response to the “Great Crash,” the Dodd-Frank Act's reforms enacted in response to the global financial crisis are at best weak.

More fundamentally, the problem is that the Fed was set up in the age of the robber barons—with little serious attempt to ensure democratic governance, oversight, and transparency. While some changes were made over the years, the Fed's response to the global financial crisis took place mostly in secret. In other words, the response to the crisis that began in 2007 looked eerily similar to J. P. Morgan's 1907 closed-door approach, with deal making that put Uncle Sam on the hook. As Greider argues, the biggest issue that still faces us is not really the lax regulation of the “too big to fail” Wall Street firms, but rather the lack of accountability of our central bank. These are issues addressed in this year's report; next year's report will tackle directly the reforms that are needed.

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This particular report draws heavily on research papers produced by Thorvald Moe, Éric Tymoigne, and Bernard Shull. However, none of these authors necessarily agrees with the conclusions of this report, which were prepared by L. Randall Wray.

Introduction: Why the Federal Reserve Needs an Overhaul²

William Greider

The Federal Reserve is celebrating its 100th birthday with due modesty, given the Fed's complicity in generating the recent financial crisis and its inability to adequately resuscitate the still-troubled economy. Woodrow Wilson signed the original Federal Reserve Act on December 23, 1913. Eleven months later, the Federal Reserve System's 12 regional banks opened for business. But in a sense the central bank was born in the autumn of 1907, when another devastating financial crisis swept the nation, destroying banks, businesses, and farmers on a frightening scale.

J. P. Morgan and his fraternity of New York bankers intervened with brutal decisiveness in the efforts to halt the Panic of 1907, choosing which banks would fail and which would survive. Afterward, Morgan was hailed in elite circles as a heroic figure who had saved the country and free-market capitalism. The nostalgia for Morgan was misplaced, however: as insiders knew, the real story of 1907 was that Washington intervened to save Wall Street—the 20th century's own inaugural bailout.

When Morgan's manipulations failed to heal the hemorrhaging banking system, the Morgan men turned to Treasury Secretary George Cortelyou and implored him to send money—lots of it. The next day, some \$25 million in emergency federal deposits were sent to New York, and the Morgan team spread the money around among the desperate banks. About the same time, Morgan dispatched two industrialists from US Steel to meet with President Teddy Roosevelt and get his assurance that the government would look the other way as they executed a corporate merger likely to violate antitrust laws.

The government saved the day, but it was a close call. Wall Street's wiser heads recognized that the country's banking system had become dangerously unstable, prone to reckless excess and recurring panics and depressions. Banking needed a safety net. Leading financiers designed one: a central bank empowered to stabilize the financial system and rescue it in times of crisis.

The bankers not only wanted access to the Federal Reserve's money but also insisted on controlling this new institution themselves. They pretty much got what they wanted. The Federal Reserve Banks in 12 major cities would literally be owned by local banks, which would function as private shareholders (they still do). The Federal Reserve Board in Washington, with governors appointed by the president, was a modest concession to democratic sensibilities.

² This chapter draws on "Why the Federal Reserve Needs an Overhaul" by William Greider, *The Nation*, February 12, 2014.

This hybrid institution, in which private economic interests share power alongside the elected government, was founded on an absurd pretense. Decisions at the Federal Reserve, it was said, should be made by disinterested technocrats, not officeholders, and deliberately shielded from the hot-blooded opinions of voters as well as politicians. Representative Carter Glass of Virginia, a leading sponsor, promised “an altruistic institution . . . , a distinctly non-partisan organization whose functions are to be wholly divorced from politics.”

Of course, the claim was ridiculous on its face. Given the enormous size of the Fed’s power to affect economic outcomes and people’s lives, the central bank’s decisions inescapably favor some interests and injure others. By controlling interest rates and the availability of credit, Fed governors necessarily referee the conflicts between lenders and debtors. Whatever you call it, that’s the realm of politics.

The remnant Populists still in Congress in 1913 were not fooled by the talk of political neutrality. Representative Robert Henry of Texas described the new central bank as “wholly in the interest of the creditor classes, the banking fraternity, and the commercial world without proper provision for the debtor classes and those who toil, produce and sustain the country.”

A hundred years later, the country seems to have circled back to the very same arguments. We are confronted again by the financial destructiveness the Fed was supposed to eliminate. Despite some worthy reforms that centralized power in Washington, bankers still run wild on occasion, ignoring restraints and spreading misery in their wake. The Fed still rushes to their rescue with lots of money—public money. And people at large still pay a terrible price for official indulgence of this very privileged sector.

So this is my brief for fundamental reform: dismantle the peculiar arrangement and democratize it. The Federal Reserve has always been a glaring contradiction of democratic values. After a century of experience, we should be able to conclude from events that the system simply doesn’t work. Or rather, it does very well for bankers, but not for ordinary citizens. The economy does require a governing authority—Fed advocates are right about that—but it suffers from the Fed’s incestuous relationship with Wall Street bankers. The best solution would be to make the decision-making process public and truly democratic by letting citizens vote on the policy. While this type of massive reform may seem difficult given the present dysfunctional political system, it is not outside the realm of possibility.

Treasury Secretary Jack Lew recently claimed that the Obama administration has eliminated the specter of “too big to fail” banks. Reform-minded critics responded with catcalls. “I’d tell him he’s living on another planet,” said Senator David Vitter, while his colleague Sherrod Brown noted that the four largest banks, after receiving bailout money in 2008, have grown by \$2 trillion. They also enjoy below-market interest rates when they borrow from credit markets and other banks because the investors figure Washington won’t let them fail.

An even harsher critic is Sheila Bair, former chair of the Federal Deposit Insurance Corporation, who had to liquidate hundreds of smaller banks during the crisis. “What system were we trying to save, anyway?” she asked in her 2012 book, *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself*. “A system in which well-connected big financial institutions get government handouts while smaller institutions and homeowners are left to fend for themselves? . . .

“Because we propped up mismanaged institutions, our financial sector remains bloated. The well-managed institutions have to compete with the boneheads,” Bair wrote. “A culture of greed and shortsightedness” permeates even the best-managed banks, one that “goes undetected by their executives and boards as well as their regulators.”

Part of that failure is because the Fed governors have not been isolated from political influence. Bankers, and their representatives at the 12 Reserve Banks, are very much insiders too. After the recent collapse, they were represented by some 20,000 lobbyists, who swamped federal regulators with formal comments and complaints on the Dodd-Frank reform law, weakening it considerably. But the heavy-handed influence of the banking industry is only part of the problem. Since citizens and their elected representatives have no voice in Federal Reserve decisions, the central bank excludes the issues, and downplays the economic consequences, that matter most to ordinary people. Instead, the monetary debate proceeds in the sanitized language of economic abstractions and is limited to a small group of elites. Self-interested financial-market participants constantly critique monetary policy, a debate reported in the business pages as though Wall Street traders were speaking for the broad public.

This reliance on a narrow frame of reference produces institutional blind spots and gross errors. I don’t doubt the integrity of Fed professionals; they sincerely believe their political isolation is a virtue. I say it is the source of their great failing. The telling evidence lies in what the Fed does not talk about. If you scan the public record over the last generation, you might conclude that the policymakers were unaware of the grave disorders that were steadily accumulating. Or that they believed the economic pressures assaulting citizens were not relevant to monetary policy. Whatever the explanation, the Fed missed the big story—the steady economic deterioration stalking the middle class—just as it did not see the reckless behavior in banking that would lead to collapse.

After the fall, the extreme inequalities of income and wealth could no longer be ignored and belatedly hit the front pages. How could the Fed—staffed by professional economists who are trained to examine broad trends—have missed the importance of this? Or that industrial wages for hourly workers had been declining in real terms for three decades? Did the governors recognize that global trade and the migration of US jobs overseas destroyed the once reliable link between rising productivity and rising wages? How did the Fed explain the mountainous debt growing inexorably across the economy—not just government debt, but household and business debt too?

Perhaps the Fed did not see the threat posed by these great shifts because the central bank was centrally implicated in causing them. Intentionally or otherwise, Fed policies

over many years have consistently favored capital over labor. The results are visible in the stunning statistics on income concentration at the wealthy pinnacle. These developments were sometimes justified in the name of fighting inflation, but the Fed also set out in other ways to improve the profitability of banking and finance. Some interests, particularly organized labor, understood what was happening and complained aloud. The Fed did not respond to the cries of distress. The mystification of monetary policy is a way of avoiding nasty arguments with the losers.

I. The Downside

During most of the past three decades, the Federal Reserve was triumphant in Washington, where politicians deferred to the wise arbiter that calmed financial anxieties and fathered good times. Recessions were infrequent and brief. Financial markets were liberated from government restraints and reached extraordinary heights. The Federal Reserve website celebrates this era as “the Great Moderation.”

An unsanctioned history would tell a less flattering story, in which the Fed contributed to the destructive forces—sometimes inadvertently, sometimes to enhance banking profitability, sometimes in pursuit of other goals. A thumbnail sketch of the action can fill in some blanks.

At the dawn of the Reagan era, while the president was cutting taxes, Fed chair Paul Volcker (a Carter appointee) was pursuing an allied goal: wage suppression. Volcker set out to break accelerating inflation (triggered mainly by increasing OPEC oil prices) by shutting down the economy with a long, harsh recession. His principal target was wages; he carried around a little card that noted the latest union contract settlements, and he told politicians the recession could not end until he had broken wages and commodity prices.

Volcker’s “wage deceleration” (his mild label) was the starting point for a seismic shift in winners and losers across the economic landscape. Labor lost the battle while capital won the war. During the bloodletting, when farmers were devastated, a delegation of farm-state legislators complained to Volcker. The Fed chair told them, “Look, your constituents are unhappy; mine aren’t.”

Volcker’s campaign was different from previous recessions induced by the central bank because he did not let up after the economy recovered. Inflation had subsided by the time Volcker ended the recession, but the Fed kept interest rates at elevated levels to squeeze out more concessions from labor. Reagan supported the Fed’s harsh medicine all the way. Republicans attributed the booming stock market to the “miracle” of supply-side economics.

The advent of globalization and the migration of US manufacturing to low-wage countries helped the central bank hold down wages at home. The Fed wanted a strong dollar to fight inflation and also to promote globalization so that US capital could invest

abroad. However, the strong dollar probably contributed to the demise of US manufacturing and to growing US indebtedness as the current account swung to deficit. By 1985, the United States had become a net debtor to the rest of the world.

During this profound shift, the central bank lost control of its central function: regulating the availability of credit. During this profound shift, the central bank lost control of its central function: regulating the availability of credit. The result was a stunning run-up of debt. Economist Jane D'Arista found that in the single decade of the 1980s, the total US debt—issued by federal, state, and local governments; households; businesses; and the financial sector—doubled. The nation's total accumulated debt since the beginning of the Republic was \$5 trillion in 1980. By 1990, it had reached \$10 trillion, and by 2007 total debt was 500 percent of US GDP. Commercial banks lost lending functions to unregulated financial markets, but the Fed's regulatory system did not keep up.

"The central bank created monetary conditions that resulted in a debt bubble," Jane D'Arista wrote in her 2013 essay on the Fed at 100. "The failure to analyze what the cumulative effect of debt might be on the real economy was the Fed's greatest failure since, in the aftermath of crises, debt remains a major impediment to the revival of economic activity." She attributed the Fed's weakening hold on credit expansion to relaxed regulatory enforcement. In 2008, the debt bubble collapsed.

Among elites, a popular explanation for the swollen debt burden was to blame the moral failings of consumers seduced by credit card culture, but that ignores the deeper causes. The faltering US economy, now faced with global competition, and the long-running trend of declining wages and disappearing jobs produced the squeeze on middle-class families. People were falling behind and trying to hang on to their standard of living. For years, they worked at more jobs and, yes, borrowed more money. Nothing provided relief, and millions lost their valiant struggle.

A stronger explanation for the mountain of debt was financial deregulation, which the Fed itself had championed. Central bankers periodically scolded the debtors and urged them to shape up, but Fed officials seldom accepted any blame. As Fed chair, Volcker supported the deregulation in 1980 that repealed legal limits on interest rates. Afterward, he acknowledged that loosening the caps on rates undermined the Fed's ability to control the expansion of credit. "The only restraining influence you have left is interest rates, restraint which works ultimately by bankrupting the customer," Volcker lamented. Sure enough, bankruptcy of the borrowers flourished in this new era of unregulated lending.

Volcker the skeptic was succeeded in 1987 by Greenspan the true believer. Alan Greenspan was an ideologue with inflated confidence that markets would sort things out better than the government. He became Wall Street's powerful cheerleader and set out to liberate the financial industry from government regulation. Instead of formulating new rules to govern the emerging "shadow banking" system, Greenspan led the charge to abolish old rules. As Fed chair, he engineered dubious legal premises in the 1990s to let Citigroup violate the Glass-Steagall Act, which had imposed a firewall between investment banking and commercial banking, even before Congress repealed that New Deal law.

The flowering of Wall Street in the Greenspan era spawned the spectacle of proliferating billionaires. By shifting rewards from labor to capital and removing restraints on financiers, the Federal Reserve helped to engineer a fantastic transformation of economic life. In 1982, when the deep recession of that time ended, the Dow Jones average was at 800. The “super bull market” peaked at 14,000 25 years later. The Dow’s value multiplied 17 times, while the overall economy grew only five times.

That contrast defines the basic economic disorder: a great shift of wealth from the many to the few, from production and consumption to the financial sector. In the early 1980s, the financial industry’s profits were about 10 percent of all corporate profits. By 2007, it was claiming 40 percent. The value of all financial assets used to average a bit more than four times the gross domestic product. By 2007, financial assets were 10 times the GDP.

Then the music stopped.

II. The Fed’s Dilemma

In the early months of 2007, on the eve of catastrophe, most members of the Federal Open Market Committee (FOMC) seemed oblivious to the crisis about to seize the financial system. In March of that year, Fed chair Ben Bernanke said he was “puzzled” that financial markets were roiled by the collapsing value of subprime mortgages. After all, he told FOMC members, “the actual money at risk is on the order of \$50 billion from defaults on subprimes, which is very small compared with the capitalization of the stock market. It looks as though a lot of the problem is coming from bad underwriting as opposed to some fundamentals in the economy.”

Bernanke’s remarks show that he did not grasp the nature of the threat or understand how the interconnections of modern finance would swiftly spread the panic from one troubled credit market to others. The Fed chair was not embarrassed by this ignorance because his remarks were made behind closed doors, at the FOMC meetings that set monetary policy. The transcripts of those 2007 meetings were not made public until five years later—long after the disclosures could have had an impact on financial markets or public opinion. The Fed’s narrow-gauge thinking and its fallibility were, as usual, protected from timely public scrutiny.

Some of Bernanke’s colleagues voiced similar complacency. “We don’t see the current situation as precipitating a cyclical downturn in aggregate activity,” said David Stockton, the director of Fed research, in reporting the staff forecast in March 2007. Jeffrey Lacker, president of the Richmond Federal Reserve Bank, seconded this overconfident view. “My overall sense of what’s going on is that an industry of originators and investors simply misjudged subprime mortgage default frequencies,” he said at the same meeting. “Realization of that risk seems to be playing out in a fairly orderly way so far.”

Michael Moskow, president of the Chicago Fed, also grossly misjudged reality. “Given the ample liquidity in financial markets, it seems unlikely that the subprime problem will

cause major changes in overall credit availability or pricing,” he said.

The transcripts of the 2007 policy meetings quoted here destroy the Fed’s popular reputation as economic soothsayer. Some FOMC members worried about inflation or oil prices or the homebuilding industry; others clung to business-as-usual optimism, even as the market news got more disturbing, with Bear Stearns and Countrywide and others sliding toward their fatal reckoning. It took six or eight months, and more violent market disturbances, for the FOMC to wake up, despite prodding and pleading from a few strong voices.

One such voice was Janet Yellen, who recently began her tenure as the new Fed chair. In March 2007, she was the first to warn that financial stability could be threatened. By August, she sounded a bit impatient with slow-moving colleagues. “We seem to be repeatedly surprised with the depth and duration of the deterioration in these markets,” Yellen observed, “and the financial fallout from developments in the subprime markets, which I now perceive to be spreading beyond that sector, is a source of appreciable angst.” As the pace quickened, William Dudley, manager of the open market desk at the New York Fed (and now its president), was a levelheaded sentinel and tutor, warning about “a danger of forced liquidation” and trying to educate FOMC members on the complexities of collateralized debt obligations and other Wall Street exotica. “The magic of structured finance and the corporate rating agencies,” Dudley explained, had been used to convert low-rated debt paper into triple-A investments. Now the investors who had bought the stuff were discovering that the assurances were false. As they started dumping failed investments, they began to wonder what else was phony, and the panic spread.

The question arose in the FOMC’s meetings: what should it tell the people? This is always the fundamental dilemma for a central bank used to deliberating in private. Does a public institution that sees a threatening storm have an obligation to inform the public at large—that is, give citizens fair warning of what’s about to happen to them? Or would that only make things worse? To put it another way, in a public-private institution, who gets to know the secrets? As events darkened in 2007, the dilemma nagged policymakers.

“I am worried that we will be asked publicly at different intervals and perhaps starting now what our opinions and perspectives are,” Richard Fisher, president of the Dallas Fed, said in August. “I’m also worried about giving the wrong answer.”

William Poole, president of the St. Louis Fed, likewise asked Dudley if the New York Fed had “what I would call material nonpublic information about firms that would suggest there is more difficulty than we see in newspapers.” Poole nevertheless said, “My own bet is that the financial market upset is not going to change fundamentally what’s going on in the real economy.”

Eric Rosengren, president of the Boston Fed, was not so sure: “Some of the Boston hedge fund managers have observed that one dependable correlation has been that the announcement of no problem seems to be highly correlated with the actual problem’s

occurring with a lag of one to two weeks,” he said. There was laughter around the boardroom table, the transcript reported.

The anxious queries were clearly about what to tell the financial markets, but the same point ought to apply to informing the public. If a government agency knows that bad things are about to happen to innocent citizens, doesn’t it have a duty to tell them—in language they can understand?

Timothy Geithner, then president of the New York Fed and later Obama’s treasury secretary, strongly warned FOMC members not to say much of anything to anyone, lest they become the trip wire for catastrophe. “The challenge, of course, is to figure out a way to acknowledge and to show some awareness of these changes in market dynamics without feeding the concern, without overreacting,” Geithner said.

The Fed more or less stuck to Geithner’s advice and essentially said nothing and did nothing. It was overtaken by events. By that point, it was not clear what, if anything, it might have done to forestall the crash. A timely warning might have helped some people get out of the way, or it might have exploded the bubble.

Yet Fed vice chair Donald Kohn still thought the dangers were exaggerated. “The most likely outcome,” he said in August 2007, “is that [the correction] will be limited in duration and effect.” How wrong was he? By September, FOMC chair Bernanke sounded less sure. Whatever the Fed did, he joked, it was sure to be criticized. “We are not in the business of bailing out individuals or businesses,” he said. “As long as we make that distinction, I think we’re fine, but it may be history that agrees to that rather than the newspapers.”

A year later, the Federal Reserve and Congress were bailing out the banks.

III. The Reform Imperative

One hundred years is enough. The main trouble with the Federal Reserve is not incompetence or bias. The problem is more fundamental. The institution is a governing antique, designed for circumstances that no longer exist. It resembles a narrow-gauge railroad built in the age of steam engines and industrial capitalism, while the world has moved on to jet travel, smartphones, and instant global banking. The Fed regularly flounders because everything has changed—except the central bank.

Congress created the Federal Reserve, and Congress can change it whenever the elected representatives get serious about reform. Clearly, that is not now the case, but it is likely to change in the future. Citizens are still absorbing the shock of what they learned about the bailouts. People are still bleeding while governing elites congratulate the central bank for “saving” the country.

Reform begins by eliminating obvious contradictions. Get the money lenders out of the

temple. Create a new public institution that truly understands that its obligation is to society, not money markets. A new Fed charter would establish an agency surrounded by numerous webs of public accountability, not only to elected officeholders but also to citizens, interests, and social aspirations now excluded from the monetary debate. The new Fed would be required to coordinate with fiscal policymakers in Congress and the White House instead of ridiculously pulling in the opposite direction, as it has done in recent years. Careful cooperation with the fiscal side of government can harness the Fed's money creation and lending powers to help finance major public objectives like infrastructure and college loans and greater employee ownership. These and other great goals are now blocked by the tyranny of outdated thinking.

Some will object that these reforms would politicize the Federal Reserve. Yes, it's true. That's the idea: listen to the people. The Fed, after all, is already politicized. It's only the people who get left out.

CHAPTER 1. Financial Crisis Resolution and Federal Reserve Governance³

Bernard Shull

I. Introduction

The Federal Reserve has been criticized for not forestalling the financial crisis of 2007–09, and for its unconventional monetary policies that have followed.⁴ Its critics have raised questions as to who, if anyone, reins in the Federal Reserve if and when its policies are misguided or abusive; that is, questions as to governance.

This chapter traces the principal changes in governance of the Federal Reserve over its history, excepting its war-era commitment years to the Treasury. The changes have, for the most part, developed in the wake of economic upheavals, when Federal Reserve policy has, as recently, been challenged. The aim is to identify relevant issues regarding governance, and to establish a basis for change, if needed.

Chapter 2 briefly reviews the concept of governance. Chapter 3 describes the principal governance mechanism established by the Federal Reserve Act in 1913. Chapter 4 traces the passing of this mechanism in the 1920s and 1930s, as well as congressional efforts to expand oversight in the 1970s. Chapter 5 considers the changes in Federal Reserve policies induced by the financial crisis of 2007–09 and the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Chapter 6 evaluates developments over time and their implications.

At its origin, Federal Reserve governance was principally instituted internally through a fragmented system that provided a set of checks and balances. The original arrangement eroded in the 1920s under the pressure of a new mandate for economic stabilization. Subsequent changes have left governance to external measures and, in particular, congressional oversight. External measures, however, have been limited. It is concluded

³ This chapter draws on “Financial Crisis Resolution and Federal Reserve Governance: Economic Thought and Political Realities” by Bernard Shull, Working Paper No. 784, Levy Economics Institute of Bard College, January 2014.

⁴ On Federal Reserve policies during the crisis, see Bernanke (2012). For a critique of Federal Reserve monetary and regulatory policies leading to the crisis, see *Financial Crisis Inquiry Report* (2011), pp. xvi, xvii. The report finds that the housing bubble that precipitated the crisis was “fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages.” It also notes “the Federal Reserve’s pivotal failure to stem the flow of toxic mortgages.” For a critique of Federal Reserve merger policy that over the previous 25 years had augmented the size of banking companies that proved “too big to fail,” see Shull (2010). A number of economists have questioned the Fed’s policies since the crisis in the public press, criticizing “centralized control by a few government officials.” See Schultz et al. (2012), p. A19. See also, Cochrane (2012), p. A13, and Bhide and Phelps (2013). A number of bills have been introduced in Congress to further reconsider and possibly alter Federal Reserve organizational structure and behavior. These include the “Sound Dollar Act of 2012,” the “Federal Reserve Transparency Act of 2012,” and the “Centennial Monetary Commission Act of 2013.”

that the absence of fully effective governance poses a threat, not simply to “stakeholders,” but to the independence of the Federal Reserve itself.

II. Governance

Modern analysis of governance, particularly as applicable to corporations, has developed over the past several decades.⁵ However, the conditions motivating governance have existed at least since the advent of the modern corporation that separated ownership from control. Today, governance mechanisms are deemed necessary for almost all large organizations to check the unlawful, opportunistic, and otherwise misguided conduct of managers (“agents”) that affect the welfare of those who have little if any influence over their policies and behavior (“stakeholders”).

For private corporations, internal governance may reside internally in formal lines of authority, and in boards of directors; it includes external mechanisms and procedures, such as outside audits and, also, competitive markets for capital and control. Such mechanisms typically provide for some degree of transparency and accountability, often to an impartial governing body. It is generally recognized that governance constitutes an essential foundation for legitimacy.⁶

Independent government agencies are also subject to governance arrangements within a paradigm established in the late 19th century in the United States. In general, agencies such as the Interstate Commerce Commission (ICC), Federal Trade Commission (FTC), National Labor Relations Board (NLRB), and Securities and Exchange Commission (SEC) have extensive discretion in implementing laws through rules and regulations, and in formulating policies. Their policies and decisions were to be insulated from politics, with principal agency officials subject to removal only for cause. In recent years, most agencies have housed an inspector general to review systems and practices aimed at preventing fraud, waste, abuse, and legal violations. Governance, in general, was to be exercised by congressional oversight.

The Federal Reserve System can, today, be classified as an independent agency of government. But there are differences that keep it more insulated than others, including self-financing and the widespread conviction that detailed monitoring of its core function, monetary policy, by Congress or any other external body, would damage the policy itself. Thus, audits by the General Accountability Office (GAO) have excluded monetary and related matters. Other governance mechanisms do exist, including internal audits, and external reviews by private accounting firms; the Board of Governors and Reserve Bank boards of directors monitor the Reserve Banks. An inspector general also functions at the Board of Governors. But none of these measures are intended to govern the discretionary decision making of Federal Reserve officials in monetary, regulatory, and related areas.

⁵ Literature on the role of governance for private corporations is extensive. See, for example, Monks and Minow (1995), Shleifer and Vishny (1997), and Gup (2007).

⁶ Monks and Minow (1995), pp. 21–22.

III. Governance at the Federal Reserve's Origin

After the Panic of 1907 in the United States, it became apparent that a central bank, or something resembling one, was needed to mitigate financial upheavals. The banking community would have welcomed a privately owned central bank, such as the Bank of England. It did welcome the Aldrich plan for a "National Reserve Association," effectively controlled by bankers. The Democratic Party, in power at the time, rejected both as transferring Congress's constitutional authority "to coin money [and] regulate the value thereof" to private banking interests, believing doing so would increase the concentration of power in the hands of large Wall Street banking companies.

Another possibility was a central bank fully owned and controlled by the government. During the Bank War of the 1830s, Andrew Jackson had, at one point, considered a Treasury bank to replace the Bank of the United States.⁷ In 1913, about the time Congressman Carter Glass had a Federal Reserve bill he believed President Wilson would support, Treasury Secretary William MacAdoo proposed a central bank in the Treasury. Glass successfully opposed the proposal, knowing it would be unacceptable to bankers whose cooperation he believed was necessary.⁸

The Glass-Owen bill that was finally adopted established the now well-known decentralized and fragmented Federal Reserve System.⁹ The design, it has been said, embraced "the principles of federalism and democracy."¹⁰ In addition to multiple, quasi-autonomous Reserve Banks, it provided representational authority for the major interest groups in the country. The Board was to include members, no more than one from any reserve district, with "fair representation of the financial, industrial, and commercial interests and geographic divisions of the country," as well as the executive branch through the treasury secretary and the comptroller of the currency.¹¹ The Reserve Banks were to be overseen by boards of directors with nine members: three representing lenders (bankers), three representing borrowers (nonbankers engaged in "commerce, agriculture or some other industrial pursuit"), and three public members (appointed by the Federal Reserve Board).¹² The Board was expected to oversee and influence the operations of the Reserve

⁷ Remini (1967), pp. 59–60; Madeleine (1943), pp. 45–48.

⁸ The proposal was probably supported by Senator Robert Owens of Oklahoma, Secretary of State Williams Jennings Bryan, and Comptroller of the Currency John Skelton Williams; see Link (1956), pp. 205ff. Glass (1927, p. 111) reported that the proposal sent him into a spasm of hallucination in which he was tormented by the ghost of Andrew Jackson.

⁹ The report of the House Committee on Banking and Currency stated that centralization "is not necessary in order to obtain the benefits [of a central bank]" (*Changes in the Banking and Currency System of the United States* 1913, pp. 12, 28–30). On the relationship of the organizational form to the National Reserve Association, see Wicker (2005), pp. 92–93.

¹⁰ Wicker (2005), p. 94.

¹¹ As to the appointed board members, section 10 of the Federal Reserve Act provided (and still does) that "not more than one . . . shall be selected from any one Federal reserve district, [and] the President shall have due regard to a fair representation of the different commercial, industrial and geographical divisions of the country." The board was not to include anyone currently engaged in banking.

¹² The boards were to appoint Reserve Bank officials, including a principal official to whom they gave the title "Governor."

Banks through the public members of their boards and, in particular, the public member selected as chairman and Federal Reserve agent. The Reserve Banks, in turn, were expected to have influence on the Board through a Federal Advisory Council made up of 12 bankers, one appointed by each Reserve Bank. Diversity and fragmented authority could be expected to produce a “clash of interests,” and relied on to reduce the likelihood of objectionable policies.¹³ The checks and balances thus constituted a form of internal governance.

Backing up this arrangement were limits on policy imposed by gold reserve requirements on deposit and note liabilities, Treasury audits of the Board, and congressional oversight.¹⁴ Both the Treasury and Congress, however, would presumably be constrained by the aim to keep the System free of partisan politics. The Board, according to the report of the House Committee on Banking and Currency, was to be “a distinctly nonpartisan organization and was to be wholly divorced from politics.”¹⁵ In fact, the report indicated that Congress wanted as little to do with banking as possible. The Federal Reserve would allow “the government . . . [to] be completely ‘out of the banking business’ . . . neither under the necessity of interfering with normal trade operations nor of artificially interposing to bolster up weak banks in any part of the country.”¹⁶ Congress also hedged its bets by giving the Reserve Banks 20-year charters, a sort of probationary term identical to the charter durations for the First and Second Banks of the United States.

Whether or not this structural arrangement could produce good policy was moot. Paul Warburg, a principal author of the Aldrich plan and an original member of the Board, saw it as a “system of checks and counterchecks— a paralyzing system which gives powers with one hand and takes them away with the other.”¹⁷ Almost two decades later, when significant changes in Federal Reserve structure were being debated, Karl Bopp, an economist who subsequently became president of the Federal Reserve Bank of Philadelphia, observed that the original system was a “structure so complicated that a consistent long-run policy is scarcely possible.”¹⁸

¹³ See Bopp (1935), pp. 11–12.

¹⁴ Audit arrangements from the Federal Reserve’s origin through 1975, are described by Governor George Mitchell in testimony before the House Subcommittee on Domestic Monetary Policy as reported in *The Federal Reserve Audit Proposal* (1975), pp. 5, 6. Treasury auditing authority was transferred to the GAO when it was established in 1921, eliminated by the Banking Act of 1933, and restored for limited purposes in 1978. Also see Kettl (1986), pp. 154ff.

¹⁵ See *Changes in the Banking and Currency System of the United States* (1913), p. 43. The House report also stated that “in order . . . to guard absolutely against any suspicion of political bias . . . , it has been deemed expedient to provide in the law against a preponderance of members of one party.” This provision was not included in the final legislation. The Senate bill also included a provision (struck out in conference) that not more than two members of the board should be from the same political party. See *Banking and Currency Bill* (1913), p. 25.

¹⁶ *Changes in the Banking and Currency System of the United States* (1913), p. 30.

¹⁷ Warburg (1930), p. 166.

¹⁸ Bopp (1932) p. 379.

IV. The Passing of Multiple-interest Governance

Between Paul Warburg and Karl Bopp, much had changed. At its origin, System aims were limited, and the nature and extent of how it would function were uncertain. It was not even clear that it would operate continuously. In its *First Annual Report*, the Board felt obliged to state that Reserve Banks would do so in order to supervise banks, as well as providing an elastic currency in “extraordinary times.”¹⁹ Congress, at the time, did not have the business cycle in mind.²⁰

By the early 1920s, however, both Congress and the Federal Reserve were alert to the cyclical performance of the economy and to the stabilizing role monetary policy could play. A new stabilization objective shattered the System’s original internal governance arrangement. The next three sections trace changes following the financial upheaval of 1919–21, the depression of the 1930s, and the stagflation years of the 1970s.²¹

A. Erosion after World War I

Before World War I, the Federal Reserve had, in Benjamin Strong’s words, been unable “to find a normal and natural place in the banking structure of the country.”²² It found a “place” during the war, supporting government borrowing. The Treasury’s *Annual Report for 1917* stated that without the Federal Reserve “it would be impossible . . . to raise the . . . credits . . . to take care of the extraordinary expenditures entailed by our part in the war.”²³

Continued support of Treasury financing following the war shackled monetary restraint in the face of inflation. Then, belated increases in Reserve Bank discount rates beginning in December 1919 and continuing into the spring of 1920 contributed to a sharp economic contraction and a precipitous decline in farm prices. Some critics called for Congress to limit Reserve Bank authority to raise discount rates without its approval.²⁴

Postwar concerns about the farm sector had independently led Congress to establish a Joint Commission for Agricultural Inquiry. The commission added “the adequacy of credit resources” (Federal Reserve policy) to its agenda.

¹⁹ Federal Reserve Board (1914), p. 18.

²⁰ Irving Fisher’s theory of “crises” had been laid out in *The Purchasing Power of Money*, published in 1911. Wesley Claire Mitchell’s seminal work, *Business Cycles*, was published in 1913. The business cycle was not mentioned in any of the 30-plus volumes of the National Monetary Commission, or in the reports of the principal congressional committees through which the Federal Reserve bill passed.

²¹ These three sections draw on Shull (2005), chap. 3–5.

²² As quoted in Chandler (1958), p. 101.

²³ US Treasury (1918), p. 21; see also, Chandler (1958), p. 102. On the other hand, the report of the American Economic Association’s Committee on War Finance in 1918 objected to the policies that permitted the Treasury to sell securities at below market rates, arguing that the Treasury should have relied more on taxes. The committee was chaired by E. R. A. Seligman and its members included E. W. Kemmerer, O. M. W. Sprague, and H. Parker Willis, among others. On the Federal Reserve’s rationale, see Strong (1922b), pp. 1, 2.

²⁴ Meltzer (2003–09), Vol. 1, p. 127.

The joint commission held hearings on Federal Reserve policy in the summer of 1921.²⁵ The Federal Reserve's principal critic, Woodrow Wilson's comptroller of the currency John Skelton Williams, claimed, among other things, that the Reserve Banks discriminated against rural banks, and that the Federal Reserve's policy mistakes stemmed from control by the large banking houses in New York.²⁶ He called for the termination of all Federal Reserve Board members from office on grounds of malfeasance and incompetence.²⁷

The joint commission's report in 1922 was mildly critical of the Federal Reserve. It deplored the delay in raising discount rates in 1919. We "cannot excuse the action . . . in this period in failing to take measures to restrict the expansion, inflation, speculation and extravagance."²⁸ But the report also reflected the new awareness of "business cycles of great prosperity and succeeding great depression, such as that from which we are now emerging."²⁹ In effect, its conclusions provided a warrant for monetary policy, independent of the Treasury, to aim at countering economic instability. The sensibilities of the day, as some Federal Reserve officials saw them, imposed a duty to do so. Adolph Miller, an economist and Board member, addressed a joint conference of Reserve Bank governors and chairmen in October 1921. He stated:

"The American people will never stand contraction if they know it can be helped. Least of all will they stand contraction if they think it is contraction at the instance, or with the consent of an institution like the Federal Reserve System. . . . The Reserve System cannot 'make' the business situation but it can do an immense deal to make its extremes less pronounced and violent. . . . Discount policy . . . should always address itself to the phase of the business cycle through which the country happens to be passing."³⁰

Stabilization policies, however, required coordination among the "clashing interests" that composed the Federal Reserve System. Open market operations, long understood but not previously utilized by the Federal Reserve for policy purposes, were initially coordinated in 1922 through a Reserve Bank committee organized by Governor Strong.³¹ This group became the Open Market Investment Committee the following year. With intent to make open market operations effective and wary, after the political firestorm in 1920, of trying to

²⁵ *Agricultural Inquiry* (1921).

²⁶ Some authorities have indicated that the joint commission was established in response to John Skelton Williams's attack on the Federal Reserve. See Kettl (1986), p. 28, and Wicker (1966), p. 55. However, according to Governor Harding, the charges made by Williams led the board itself to request an investigation by the Senate Banking and Currency Committee; that committee referred the matter to the joint commission, already established. The commission, thereafter, included the Federal Reserve policy to the other issues it planned to investigate. See Harding (1925), p. 219.

²⁷ As reported by Harding (1925), p. 209.

²⁸ *Report of the Joint Commission on Agricultural Inquiry* (1922), p. 15.

²⁹ *Report of the Joint Commission on Agricultural Inquiry* (1922), pp. 11–12.

³⁰ Quoted in Miller (1921), pp. 10, 11. See also, Federal Reserve Board (1924), pp. 11ff.

³¹ Governor Strong's explanation of how open market operations began can be found in *Stabilization* (1926), Part I, p. 309. For a discussion of the extent to which open market operations were understood as a policy tool prior to the 1920s, see Shull 2005, pp. 90–93.

restrict discounting by raising discount rates, the Board formulated new System-wide rules establishing a “reluctance-to-borrow,” nonprice-rationing basis for Reserve Bank lending.³² New guides for policy were developed.³³

Coordination in the 1920s was far from perfect.³⁴ But what was done provided a strong indication that, with economic stabilization as a goal, “checks-and-balances/clash-of-interest” governance was impracticable. Governance, if there were to be any, would be left to Congress.

As noted, the GAO took over for the Treasury in auditing the Board (but not the Reserve Banks) in 1921. Congress, itself, had already intervened through its Joint Commission in early 1922. From 1926 into 1928, the House Committee on Banking and Currency held hearings on a bill and its variants requiring the Federal Reserve to promote stable prices.³⁵ Had it passed, it would have established a “rule” that would provide at least a partial substitute for the original, internal governance.³⁶ It did not pass.

By 1927, in any event, Congress was sufficiently pleased with the central bank’s performance to provide, in the Pepper-McFadden Act, Reserve Bank charters of indefinite duration to replace the 20-year charters it had granted in 1913. The Senate report on the Act noted that “the Federal reserve system has demonstrated its usefulness . . . and has been recognized throughout the world as the best banking system ever brought into existence.”³⁷

³² The Reserve Banks had authority, provided by section 14 of the Federal Reserve Act, to purchase and sell securities in the open market “under rules and regulations” of the board. The board indicated that they could do so “within the limits of prudence, as they might see fit” (Federal Reserve Board 1914, pp. 155–56). On the discount mechanism rules to accommodate open market operations as a policy tool, see Shull (1971), pp. 33ff.

³³ Federal Reserve Board (1924). With the major countries in the world off the gold standard, Adolph Miller also told the joint conference of governors and chairmen in 1921 that the gold reserve ratio was “almost worse than useless as a guide to changes in discount rates” (Miller 1921, p. 14).

³⁴ Congress continued to give credence to checks-and-balances governance. In June 1922, it amended section 10 of the Federal Reserve Act to increase the number of board members from five to six in order to add a representative of agricultural interests to those already mentioned in the law. Conflict within the Federal Reserve System continued through the decade, with policy variations among Reserve Banks, and between Reserve Banks and the Board of Governors. The board’s influence on the Reserve Banks through the public members on their boards and, in particular, through the chairman/Federal Reserve agent was, it appears, largely frustrated (Bopp 1935, pp. 11, 38, 46ff.)

³⁵ *Stabilization* (1926–27, 1928). The Senate bill in 1913 had contained a provision instructing the Federal Reserve to “promote stability in the price level” that, according to John R. Commons, George Shibley, a businessman and economics writer, had persuaded Senator Owen to insert (Commons 1963 [1934], p. 64). The provision was eliminated in conference (Willis 1985 [1923], pp. 1605–26; Fisher 1928, pp. 225–26). It was dropped, according to Commons, because President Wilson opposed it. It is of interest that Shibley was the first witness in the *Stabilization* hearings in the House in 1926 on the amendment to the Federal Reserve Act, sponsored by James Strong of Kansas, that would have required “all of the powers of the Federal reserve system [to] be used for promoting stability in the price level.”

³⁶ See Fisher (1934) and Commons (1925), p. 51.

³⁷ See *National Bank Act, Report* (1926), p. 14.

B. Restructuring in the Great Depression

In the wake of the System's futility in the early 1930s, both economists and bankers made serious proposals to do away with privately owned Reserve Banks.³⁸ An initial congressional response in 1932 was to broaden the Federal Reserve's authority to extend additional credit.³⁹ In 1933–34, congressional legislation strengthened the Board, by eliminating GAO audits, among other things.⁴⁰

By November 1934, the Roosevelt administration at the urging of Marriner Eccles, newly appointed to the Board, was prepared to undertake a significant reorganization.⁴¹ In a memorandum to the president, Eccles had asserted that the System failed because (1) "the diffusion of power and responsibility" can result in "a complete stalemate;" and (2) the governors of the Reserve Banks control open market operations and were "profoundly influenced by narrow banking rather than a broad social point of view."⁴² He expressed concern that the Reserve Banks might sabotage Roosevelt's deficit financing plans.⁴³ Roosevelt had similar concerns and considered, at one point, government ownership of the Reserve Banks.⁴⁴

Reorganization was undertaken in Title II of the Banking Act of 1935. Eccles proposed to reorganize the FOMC to include only Board members. He also proposed legislative language to make clear that each Board member represented the national interest, not regional or commercial interests—that is, expressed "a broad social point of view."⁴⁵

³⁸ In 1933, a group of University of Chicago economists, including Frank Knight, Lloyd Mints, Henry Schultz, Henry Simons, Aaron Director, and Paul Douglas, proposed government ownership of Reserve Banks (Kennedy 1973, pp. 166–67). The Economic Policy Commission of the American Bankers Association proposed that Reserve Banks be converted to branches of the Board (Burns 1974, p. 82).

³⁹ The first Glass-Steagall Act in February 1932 and the Emergency Relief and Construction Act in July expanded the Federal Reserve's capacities to extend credit through open market operations and at the discount window.

⁴⁰ Among other things, the Banking Act of 1933 gave the Board authority to raise reserve requirements in emergencies and the sole authority over bank holding companies. It raised the salaries of Board members and lengthened their terms of office from 10 to 12 years. The Securities Exchange Act of 1934 gave the Board authority to establish margin requirements.

⁴¹ See chapters 2 and 3 below.

⁴² Eccles (1934).

⁴³ Eccles (1934), p. 166, and Eccles (1951), p. 187.

⁴⁴ See Ickes (1953), pp. 108–09; and Schlesinger (1959), p. 248. During the hearings on the 1935 Act Roosevelt responded (off the record) to a reporter's question about the possible government purchase of Reserve Bank stock by recalling that during the fight between Jackson and Biddle an adviser had suggested the government obtain a majority interest in the Second Bank. He observed that "that . . . would have solved the banking situation . . . in a much more satisfactory way . . . during the next ten years." A reporter then asked, did you say "next" or "last ten years." Roosevelt is reported to have joined in the laughter (Blum 1959, p. 349).

⁴⁵ The original wording he proposed was: "In selecting . . . members . . . the President shall choose persons . . . to participate in the formulation of national economic and monetary policies" (Bopp 1935, p. 12).

His proposals sparked controversy. Treasury Secretary Morgenthau initially opted for government ownership of Reserve Bank stock.⁴⁶ But he objected to placing full authority with a Board of Governors he believed had resisted cooperation with the Treasury. At the same time, he made clear that he did not want the System to be taken over by the Treasury. At one point he suggested disinterested experts run the central bank.⁴⁷ Carter Glass objected to Eccles's proposals. He believed that Reserve Bank involvement in policy was necessary. Moreover, he argued, the System "was never intended . . . [to] be used as an adjunct of the Treasury."⁴⁸

A central bank in the Treasury would, for good or bad, have resolved the governance issue. But neither Glass, who believed banker participation was needed, nor Morgenthau was interested.

Title II of the Banking Act of 1935 was a compromise. The new Board of Governors constituted a majority, but not sole representation on the FOMC. In addition to definitive authority over discount rates, and new authority over reserve requirements, the Reserve Bank presidents selected by their directors were made subject to Board approval.⁴⁹ In a gesture toward independence from the Treasury, something Glass had wanted, the treasury secretary and the comptroller of the currency were removed from the Board.

The old language of the law remained in the Banking Act of 1935, requiring that there be no more than one Board member from any one district, and urging that the president have due regard for diverse economic interests in his appointments to the Board. The Reserve Banks were still owned by their member banks, and their boards of directors were sustained in the original configuration. But under the chairmanship of Mariner Eccles, it was expected that the Board members, whatever their backgrounds, would focus on the national interest. Reserve Bank presidents were confronted by some ambiguity. They remained responsible to their diverse boards of directors, member banks, and regional districts; but the reorganization appeared to oblige them in their functions as FOMC members to place the national interest first. Eccles, nevertheless, continued to express concerns about Reserve Bank participation in policy.⁵⁰ Congressman Wright Patman, and subsequently others, repeatedly proposed government ownership of the Banks.⁵¹

The transfer of principal authority to the Board went a considerable distance to codify the centralization of the Federal Reserve initiated in the 1920s, and to memorializing the disintegration of checks-and-balances/clash-of-interest governance. Congressional

⁴⁶ Blum (1959), pp. 346–49.

⁴⁷ In addition to Blum (1959), see *Banking Act of 1935* (1935), pp. 312–14; and Ickes (1953), pp. 534–35.

⁴⁸ As quoted in Westerfield (1933), pp. 727–28

⁴⁹ The titles of System officials and their terms in office were changed to emphasize the shift in authority from the Reserve Banks to the Board.

⁵⁰ Eccles (1938) as reprinted in Weissman (1973), pp. 142–44.

⁵¹ See, for example, *Government Ownership of the Twelve Federal Reserve Banks* (1938).

oversight remained. But Eccles foreshadowed later chairmen by expressing concern about the intrusion of Congress into monetary policy, even given the elimination of GAO audits.⁵²

C. Congressional oversight in the 1970s

A long period of Treasury domination of the Federal Reserve, during and following World War II, ended with the Accord of 1951.⁵³ The Federal Reserve reestablished independent monetary policy, confident that interest rates need not change much to achieve desired results. It also decided to conduct open market operations principally in short-term Treasury bills, intending to interfere as little as possible with other financial markets. Subsequent developments, including adaptive changes in financial markets and the oil crisis in the early 1970s, disrupted this limited approach. By 1975, with unemployment rising to over 8 percent and inflation running at over 9 percent, monetary policy seemed confounded.

In 1975, Congress took steps to elevate its oversight. It explicitly asserted its constitutional authority in "House Resolution 133" of March 1975 (with the Senate concurring) to exert influence on both the Fed's monetary targets and strategy. The resolution declared that the Board and the FOMC should: "(1) pursue policies . . . to encourage lower long term interest rates and expansion in monetary and credit aggregates appropriate to facilitating prompt economic recovery; and (2) maintain the long run growth . . . [of these aggregates] to promote . . . maximum employment, stable prices, and moderate long term interest rates." It called on the Board to consult with Congress at semiannual hearings about objectives and plans on the aggregates in the upcoming 12 months. It concluded by stating that nothing in the resolution should be interpreted to require specific growth or diminution in the aggregates if the Board and the FOMC determined that they could not or should not meet these objectives. In such cases, "they shall report to Congress the reasons."⁵⁴

The Federal Reserve Reform Act of 1977 established comparable statutory obligations in addition to requiring Senate confirmation for the presidential appointments of Board chairman and vice chairman. Continuing the long retreat from the original internal governance, the Act also modified the character of Class B Reserve Bank directors. The new language required that they be "elected to represent the public" and "with due *but not exclusive consideration* to the interests of agriculture, commerce, industry, services, labor, and consumers [emphasis added]."

This line of congressional intervention culminated in 1978 with passage of the Humphrey-Hawkins Full Employment and Balanced Growth Act that established national objectives for full employment and price stability. Again, the Board and the FOMC were to establish monetary and credit aggregates consistent with national economic goals, and Board

⁵² See Blum (1959), p. 351.

⁵³ See chapters 2 and 3 below.

⁵⁴ H. Con. Res. 133, March 24, 1975. See also, *The Impact of the Federal Reserve System's Monetary Policies on the Nation's Economy* (1976), pp. 49-50.

chairmen were to present semiannual reports to the Senate and House banking committees on current conditions, prospects, and targets. Again, the Act provided that it should not be interpreted to require that “objectives and plans with respect to the ranges of growth or diminution of the monetary and credit aggregates . . . be achieved if the Board of Governors and the Federal Open Market Committee determine that they cannot or should not . . . because of changing conditions.” Heightened congressional oversight including the establishment of semiannual reports and hearings made the Federal Reserve more transparent. But their effectiveness as a method of governance remained problematic.⁵⁵

In line with Congress’s reformulation of its oversight responsibilities, the Federal Banking Agency Audit Act of 1978 restored GAO authority to audit the Fed. The authority now provided for audits of Reserve Banks as well as the Board. But, as noted, it excluded monetary policy and related areas.⁵⁶

The Federal Reserve’s efforts to extinguish inflationary expectations, beginning in October 1979, produced extraordinary interest rate volatility and widespread collateral damage. Bitter complaints emanated from farmers, the building trades, and community groups. Academic criticism focused on Federal Reserve policy that had been too easy in the 1970s, and then reversed itself too sharply in the early 1980s.⁵⁷ Milton Friedman found an underlying cause for the Federal Reserve’s mistakes in its insulation from market constraints, elections, and the normal government budgetary process;⁵⁸ that is, *in the inadequacy of governance*. Disappointed in its performance and its unwillingness to accept a monetary “rule,” he proposed, at one point, that it might be made “either . . . a bureau in the Treasury . . . or . . . [placed] under direct congressional control.”⁵⁹

V. The Financial Crisis: Dodd-Frank Modifications

The restoration of relative interest rate and price stability after the early 1980s ushered in a period of sufficiently lowered volatility to be termed, by some economists, “the Great Moderation.”⁶⁰ The Federal Reserve still had academic critics who, particularly early in the period, saw the organization’s insularity and policymaking discretion, as a source of mismanagement and costly mistakes.⁶¹ However, as in other periods of relative economic stability, political concerns about Federal Reserve governance receded.

⁵⁵ See “Independence, Congressional Weakness, and the Importance of Appointment” (2012), pp. 1836–38; Meltzer (2003–09), Vol. 2, pp. 985–92; and Kettl (1986), pp. 149–50. For a statistical analysis of informal congressional influence on monetary policy through signaling, see Havrilesky (1995), chap. 7.

⁵⁶ An Inspector General was also installed at the Board in accordance with the Inspector General Act of 1978. For additional limitations in accorded “independence,” see *The Budgetary Status of the Federal Reserve System*, Congressional Budget Office (1985), pp. 12ff.

⁵⁷ See Friedman (1982).

⁵⁸ Friedman (1982), pp. 103, 114.

⁵⁹ Friedman (1982), p. 118. For his earlier proposal for a “rule,” see Friedman (1962), pp. 242–43.

⁶⁰ Bernanke has argued that improvements in monetary policy over that in the 1960s and 1970s was a principal underlying cause. See Bernanke (2004).

⁶¹ The intensity of the criticism is manifest in Havrilesky (1991) and Mayer (1990), pp. 1–11.

This remission ended with the financial crisis that began in 2007. With the onset of the crisis, the Federal Reserve undertook aggressive and innovative measures. It expanded access to its discount window for depository institutions, created new credit facilities for non-depository institutions, extended credit to permit the acquisition of large firms whose failures it believed would have systemic effects, and expanded its assets through the purchase of long-term governments and mortgage-backed securities from about \$700 billion to nearly \$4 trillion currently. It fashioned new monetary tools by paying interest on reserves and through “forward guidance.” Its near-zero interest rate policy has affected credit and resource allocation in the course of stimulating both the real estate and stock markets.⁶²

The Dodd-Frank legislation included measures that extended Federal Reserve authority and responsibilities, and also imposed some new controls and governance arrangements. In reorganizing agency responsibilities, it sustained Federal Reserve authority over bank holding companies and extended it to include large, systemically important nonbank financial institutions designated as such, by the newly established Financial Stability Oversight Council (FSOC).⁶³ The FSOC, composed of the heads of all agencies with financial sector responsibilities, including the Board, is chaired by the treasury secretary and now has principal responsibility for monitoring and countering systemic threats.

Dodd-Frank has also modified section 13(3) of the Federal Reserve Act, prohibiting the Federal Reserve from targeting specific nonbank companies for rescue as it did during the financial crisis with AIG and Bear Stearns. It may still provide credit to “individuals, partnerships, and corporations” (IPCs) in “unusual and exigent circumstances,” but only within a “facility or program with broad-based eligibility.” It must have Treasury approval for such programs, must consult with the Treasury as to policies and procedures, and provide reports to Congress. Dodd-Frank asserted further congressional oversight in the area of supervision by requiring the Board appoint a vice chairperson for supervision who is to periodically report to Congress on supervisory and regulatory matters.

⁶² For an earlier view on the transmission of unexpected monetary policy effects through changes in stock market values, see Bernanke and Kuttner (2004).

⁶³ These include all bank holding companies with assets in excess of \$50 billion that are, by the Act’s definition, systematically important financial institutions (SIFIs). Factors applied by the FSOC in making such designations include a company’s “scope, size, scale, concentration, interconnectedness.” In July 2012, the FSOC designated eight “financial market utilities” (clearing or settlement systems) as systematically important. In July 2013, it designated AIG and GE Capital as systematically important nonbank financial institutions. Subject to recommendations by the Council, the Fed is required to impose “enhanced prudential standards” on all SIFIs, including higher capital, leverage and liquidity requirements. SIFIs must also develop “orderly resolution” plans (“living wills”) intended to permit their liquidation without systemic impact. The Federal Reserve and FDIC have jointly issued rules for “living wills.” If a company does not submit a credible resolution plan, the Federal Reserve may determine that it “poses a grave threat to financial stability.” On a two-thirds vote of the FSOC, it can restrict mergers, acquisitions, involvement with specific financial products, and require it to sell assets. In the case of a failed banking company, the FDIC can take the company into receivership so that it continues to function until sold.

The law mandated increased transparency through a one-time GAO review of all loans and other transactions related to the Fed's emergency financial assistance during the financial crisis (December 1, 2007, and July 21, 2010); the audit included an evaluation of the effectiveness of the policies, and was completed in 2011.⁶⁴ Periodic GAO audits, however, continue to exclude monetary policy and related areas.

These changes do not directly impact the Federal Reserve's core monetary authority. But the Federal Reserve has long considered supervisory and lender-of-last-resort authority as closely related.⁶⁵

One change was aimed at reducing the role of bankers in policy formulation. Dodd-Frank excluded banker-directors (Class A) from the selection process for Reserve Bank presidents. At most, the provision bolsters the final authority over Reserve Bank presidential selections the Board has had since the Banking Act of 1935.

The full impact of the expanded role of the Treasury, and to a lesser extent Congress, on monetary policy as the result of Dodd-Frank is, as yet, unclear. As noted above, there are at present a number of bills in Congress that would constrain Federal Reserve discretion in one way or another.

VI. Discussion

Review of Federal Reserve governance reveals the role of the System's original "checks-and-balances/clash-of-interest" design, the necessity for its early deconstruction, and the subsequent reorganization that shifted authority to the Board, obliging all policymakers to focus on what Eccles termed "a broad social point of view" rather than parochial interests. These changes notwithstanding, much of the original System architecture has been retained, including continued member-bank ownership of 12 Reserve Banks, and legal language that specifies diversified economic and regional interests for policymaking officials.

The original internal governance mechanism was a crucial factor in Congress's intention to insulate the Federal Reserve from politics. Since the mechanism was crippled by System objectives that required centralization and coordination, Congress has struggled, with modest success at best, to establish an external substitute that would not interfere with the Federal Reserve's independence in formulating and implementing monetary policy.

Reorganization in the 1930s nested principal authority with a Board of Governors composed of presidential appointees, providing the executive branch with more influence than it previously had. When monetary policy independence was restored in 1951, congressional oversight remained, but was relatively unobtrusive.

⁶⁴ GAO (2011).

⁶⁵ BGFRS (1984).

By the mid-1970s, however, recognition of the impact of monetary policy on economic conditions, and the Federal Reserve's fallibility, led Congress to amplify its oversight. The measures Congress took thereafter increased transparency, but they have done little to provide the protections promised by the original governance mechanism.⁶⁶

Congressional oversight has been limited by the widely accepted belief, vigorously supported by the Federal Reserve, that monetary policy must be formulated and implemented independently.⁶⁷ Federal Reserve resistance to external monitoring has been fortified by unusually long terms for Board members, as well as "for-cause removal restrictions," self-financing, and chairpersons who have become icons with financial market constituencies. Other external governance has been attempted. In 1929, and again in the 1970s, private suits invited court intervention into monetary policy decisions that the courts notably rebuffed.⁶⁸

While governance has lagged, the Federal Reserve has grown in power and influence, principally in periods of economic disturbance for which its policies have born some responsibility.⁶⁹ The period since 2007 is the most recent example.

A rationale for "failing upward" was articulated recently by Martin Feldstein in reviewing the financial crisis that began in 2007. "The Federal Reserve," he observed, "deserves some of the blame. . . . Fortunately it has learned from its past mistakes. . . . Reforms that are adopted now should aim to strengthen [its] . . . performance . . . rather than to reduce its powers."⁷⁰

The result is that an increasingly invasive monetary policy is formulated and implemented, as former Governor Lawrence Meyer observed, solely by 19 Federal Reserve officials "known only to a minute percentage of our population—meeting regularly behind closed doors."⁷¹ None, to state the obvious, are elected.

⁶⁶ For a discussion of central bank transparency elsewhere in the world, see Crowe and Meade (2007).

⁶⁷ Chairman Bernanke, in widely reported testimony before House Financial Services Committee on July 18, 2012, responded to calls for full GAO audits by visualizing a "nightmare scenario" that would have Congress second-guessing monetary policy decisions as they were being formulated.

⁶⁸ A 1929 suit alleged that the Federal Reserve had spread propaganda concerning a shortage of money, restricted the supply of credit for investment purposes, and caused stock and bond prices to fall in value, thus depriving the plaintiff of property without due process of law (*Federal Reserve Bulletin* 1929, p. 566). The Circuit Court stated: "We can see no basis for the contention that it is a tort . . . even though . . . [Federal Reserve] policy may be mistaken and its judgment bad. The remedy sought would make the courts, rather than the Federal Reserve Board, the supervisors of the Federal Reserve System, and would involve a cure worse than the malady" (*Raichle v. Federal Reserve Bank*, 34 F.2d 910, 915 [2d Cir. 1929]). About 50 years later, a claim arising out of the Franklin National Bank failure was similarly decided: "[It] would be an unthinkable burden upon any banking system if . . . [Federal Reserve's policies] were to be subject to judicial review. Indeed, the correction of discount rates by judicial decree seems almost grotesque" (*Huntington Towers, Ltd. v. Franklin National Bank*, 559 F.2d 863, 868 [2d Cir. 1978]).

⁶⁹ For a discussion of the Federal Reserve's growth in periods of economic distress, see Shull 2005, chap. 6.

⁷⁰ Feldstein (2010), p. 143.

⁷¹ Meyer (2004), p. xi

This circumstance creates risks, not only for those affected by policy but also for the Federal Reserve itself. Growth in power without effective governance, accompanied by increased transparency, tends to make policy mistakes more obvious and less acceptable to those adversely affected and their political representatives. More than 40 years ago, Kenneth Boulding pointed out—interestingly, in a Federal Reserve publication—that the determinants of legitimacy are nonlinear and exhibit discontinuities: “Sometimes an institution, the legitimacy of which seems to be absolutely unquestioned, collapses overnight.”⁷²

Or there could simply be a continuation of the slow institutional drift toward Treasury superintendence. The FDIC Improvement Act (FDICIA, 1991) required approval by the secretary of the treasury (with agreement by the president) for Federal Reserve (and FDIC) bailouts of large banking companies—that is, the “systemic risk exception.”⁷³ Dodd-Frank subsumed critical Federal Reserve supervisory authority to the FSOC, chaired by the secretary of the treasury.

Executive branch influence over Federal Reserve policy in national emergencies, and sometimes in their absence, is nothing new.⁷⁴ Given the state of governance, it is not only conceivable but also reasonable in periods of economic distress and monetary policy misgivings for the Treasury to take on traditional System functions, moving it toward the kind of central bank that Andrew Jackson considered, William McAdoo proposed, Franklin Roosevelt suggested might solve the problems of his day, and even Milton Friedman was willing to contemplate.

It is obvious that the pressures that accompany external governance could undermine the independence of the Federal Reserve. It is, perhaps, less obvious that the absence of effective governance, particularly with a System that has become increasingly influential and invasive, can do the same.

There is now a stark contrast between the intricate counterweights that Congress established in 1913, when it transferred modest discretionary authority over money and credit to the Federal Reserve, and the murky external governance that exists today for the immeasurably more powerful institution. Their deficiencies aside, an attractive feature of a “rule” for monetary policy as supported by economists such as Irving Fisher and John R.

⁷² Boulding (1971), p. 3

⁷³ FDICIA created a systemic risk exception to the general bar on “bailouts,” requiring a joint agreement of the Federal Reserve, the FDIC, and the secretary of the treasury, with the agreement of the president.

⁷⁴ As early as 1922, Benjamin Strong recognized “the natural inclination of the Administration . . . to exert every effort possible to make business good. . . . That key is found in the Federal Reserve. . . . In other words, again cheap money” (Strong 1922a, pp. 2, 3). Presidential influence to reduce the discount rate through appointments and informal contacts was evident in the 1920s (Bopp 1935, pp. 12ff.). See also, Shull and Jacques (1995–96), pp. 227–30. For anecdotal reports on specific episodes, see Bremner (2004), pp. 205ff.; Ferrell (2010); Maisel (1973), pp. 108ff. and 146ff.; and Silber (2012), pp. 254ff. For evidence of effective Federal Reserve resistance to presidential intervention, see “Independence, Congressional Weakness, and the Importance of Appointment” (2012), pp. 1837–38.

Commons in the 1920s, Milton Friedman in the 1960s, and, more recently, John Taylor is that it resolves the governance issue. Absent a rule, the challenge to the Federal Reserve's stakeholders (that includes just about everyone) and the Federal Reserve itself are to find a substitute for the "checks and double checks" that Paul Warburg decried 100 years ago.

VII. Conclusions

Federal Reserve governance was, at its origin, principally instituted through a fragmented system that provided an internal set of checks and balances. The original arrangement eroded in the 1920s with policies aimed at smoothing out the business cycle. Governance was left to congressional oversight, limited by the general view that monetary policy should be insulated from politics.

Reorganization of the Federal Reserve in 1935 shifted authority from the Reserve Banks to the Board and codified the change from a fragmented system to a centralized organization. Congress, in the 1970s, made an effort to assert its constitutional prerogative to both monitor and alter Federal Reserve policy, but its influence has been limited.

With the dissolution of internal governance and limited external governance, the inexorable expansion of the Federal Reserve's power and influence, largely in periods of economic distress, has intensified the need for effective governance. The absence of adequate mechanisms remains a threat, not only to those affected by monetary policy, but also to the independence of the Federal Reserve itself.

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CHAPTER 2. The 1951 Treasury – Federal Reserve Accord: The Battle Over Fed Independence

Thorvald Grung Moe⁷⁵

I. Introduction

The Accord announced on March 4, 1951, between the US Treasury and the Federal Reserve has been hailed as “the start of the modern Federal Reserve System” (Hetzel and Leach 2001, p. 53) and as “a major achievement for the country” (Meltzer 2003, p. 712). It separated the Treasury’s debt management powers from the Federal Reserve’s monetary policy powers, thereby establishing an independent central bank focused on calming macroeconomic fluctuations and maintaining price stability.

Prior to the 2007–08 financial crisis, appreciation for the history of the Accord and for the importance of the conflict between the Fed and the Treasury was largely relegated to history.⁷⁶ But the global financial crisis has generated renewed interest in the Accord, and a newfound appreciation for its relevance to contemporary policymaking is emerging. The crisis has also led to renewed discussions about central bank policies and organization. For instance, Gillian Tett (2011) of the *Financial Times* has noted that the analytical framework for formulating central bank policies requires an update or even a radical overhaul. Likewise, a recent Brookings report argues that the conventional approach to central banking must be rethought (Brookings Institution 2011, p. 2).

The enormous expansion of central banks’ balance sheets has led some observers to argue that unconventional monetary policy puts central bank independence at risk (Goodfriend 2011). Stephen Cecchetti (2009, p. 70) from the Bank for International Settlements (BIS) has also observed that “the subsidy implicit in the loan to Bear Stearns was clearly a fiscal, not a monetary operation; the Federal Reserve is effectively acting as the fiscal agent for the Treasury.” And Hervé Hannoun, also from BIS, adds:

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⁷⁶ The key resource for any study of the Accord is Meltzer (2003). There is also a special issue of the Federal Reserve Bank of Richmond’s *Economic Quarterly* commemorating the 50th anniversary of the Treasury – Federal Reserve Accord (Kramer 2001). The electronic archive of the St. Louis Federal Reserve Bank contains a wealth of relevant information; <http://fraser.stlouisfed.org/>. The autobiography by Marriner Eccles (1951a) and the later biography by Sidney Hyman (1976) give a more personal perspective on the creation of the Accord. Reich (2011) includes a chapter on the relevance of Eccles’s ideas for the current financial crisis.

Avoiding fiscal dominance⁷⁷ will require decisive steps by central banks, but also by other policymakers. Central banks will need to restore a clearer separation between monetary and fiscal policy. . . . The bottom line is that monetary policy should be refocused on maintaining lasting price stability. (Hannoun 2012, pp. 20–21)

Marvin Goodfriend, formerly of the Federal Reserve Bank of Richmond, has long argued for a “New Accord” to limit the central bank’s ability to use its balance sheet for unconventional monetary policies. His basic idea is that “Congress has provided the Fed with the independence necessary to carry out central bank functions effectively, and the Fed should perform only those functions” (Goodfriend 2001, p. 31). In a more recent paper, he reiterates his proposal for a new Accord that would seek “to clarify and limit the Fed’s credit policy powers and preserve its independence on monetary and interest rate policy.” In his view, “an independent central bank cannot be relied upon to deliver or decide upon the delivery of fiscal support for the financial system” (Goodfriend 2011, p. 3).

A new Accord that assigns responsibility for all but the shortest-term lending to the Treasury would have a number of advantages, according to Jeffery Lacker from the Federal Reserve Bank of Richmond (Lacker 2009, p. 7). Mervyn King, formerly of the Bank of England, adds that the central bank “has no democratic mandate to put taxpayers’ money at risk” and remarks that he “rather doubts that central banks’ independence would survive the extension of their responsibilities into areas that are the proper domain of government” (King 2012, p. 4).

The notion that the 1951 Accord constitutes the ultimate apotheosis of central bank independence is ahistorical. Marriner S. Eccles was a key player in the events that led up to the Accord. As chairman of the Federal Reserve Board of Governors since 1934, he was instrumental in drafting key banking legislation in the mid-1930s that enabled the Federal Reserve System to take on a more independent role after the Accord. Eccles’s support for the Accord—and for central bank independence—was certainly motivated by the fact that America was near full employment and by the presence of strong inflationary pressures. Thus, Eccles’s support for tight monetary policy in the early 1950s was perfectly consistent with his earlier support for government deficit financing during the 1930s, when there had been enormous slack in the economy. For Eccles, it was “the duty of the Government to intervene in order to counteract as far as possible the twin evils of inflation and deflation” (Eccles 1935c, p. 1). The Accord “solved” the acute conflict between the Federal Reserve and the Treasury, bestowing independent control of monetary policy upon the Federal Reserve. But the Accord should not be seen as an eternal beacon glistening in support of the cause of central bank independence, but rather as simply a pragmatic and enlightened framework for symmetric policy response, designed to meet the particular economic policy challenges of the 1950s, placing equal weight on the dual objectives of fighting inflation and of preventing relapse into another Great Depression.

⁷⁷ “Fiscal policy will become active and monetary policy passive, also referred to as a situation of fiscal dominance” (Bordo 2011, p. 49).

This more historically and contextually informed interpretation of the Accord holds the key to a different view of the Accord, in which Eccles's contributions from the mid-1930s are rightly considered to be just as important as his later contributions.⁷⁸ Though central bank independence is important, it cannot be blithely heralded as an absolute, inviolable virtue regardless of the state of the economy. Eccles favored entrusting central banks with broad objectives, including full employment and price stability. Eccles valued the Federal Reserve's independence. However, he did not value its independence at the cost of those broad objectives. He therefore preferred a coordinated approach between fiscal policy and monetary policy to achieve full employment and "a decent living for every working man and woman." This strong, morally grounded stance constitutes Eccles's lasting legacy. It is also his main message to modern policymakers who face inertly depressed economies and who confront the grim specter of mass unemployment.

Today, monetary and fiscal authorities in Europe and the United States are locked in an "elaborate pas de deux" (*Financial Times* 2012) as they try to agree on adequate policy responses to the world's massive unemployment problem. This high-stakes poker game between central bankers and politicians has all the ingredients of the Accord drama. The difference was that in the 1950s there was low unemployment and a perceived risk of inflation, while this time there is high unemployment and low inflation. Eccles would surely have concluded that central bankers today are drawing the wrong lessons from the 1951 Accord, and would have urged them to instead heed his Depression-era policy advice (deficit financing and accommodative monetary policy), which is better suited to current conditions:

The problem with this prescription of course is that it goes against decades of deeply entrenched economic orthodoxies—that balanced budgets and central bank independence are always good and that monetary financing of deficits is always inflationary.⁷⁹ (McCulley and Pozsar 2012, p. 12)

A review of Eccles's policy views and the history of the Accord should therefore provide a better background for understanding the essential point of the Accord and its relevance to the ongoing discussion of central bank independence and monetary policy reform. We will review Eccles's views on war financing and the way World War II was actually financed in the United States. This will lead to "the battle of the peg" and the drama that led to the 1951 Accord. Finally, we will conclude with an assessment of Eccles's role in the making of the Accord, and with a discussion of the lessons we should draw today for central bank independence and for the conduct of monetary policy.

⁷⁸ Vernengo (2006) provides supporting evidence for this interpretation of Eccles's policy views. Epstein and Schor (2011) add to this perspective.

⁷⁹ *Monetary financing (monetization)* is a two-step process where the government issues debt to finance its spending and the central bank purchases the debt, leaving the system with an increased supply of base money.

II. Marriner Eccles—Architect of the New Federal Reserve

On March 5, 1933, just two days after his inauguration, President Franklin D. Roosevelt declared a nationwide banking holiday. Four days later, Congress passed the Emergency Banking Act, which granted the president emergency powers to regulate credit, currency, and foreign exchange. After the bank holiday, most sound banks reopened with government guarantees, while other banks remained closed and were resolved. Eccles supported these policy measures, but was appalled by President Roosevelt's continued rhetorical and substantive attachment to "balanced" budgets. Eccles wrote an angry note to his business associates, including to his politically connected friends in Washington, stating that "it seems to me that if the proposed budget-balancing policy is carried out, it can only result in further drastic deflation, a further decrease in buying power and a great increase in unemployment" (quoted in Hyman 1976, p. 117).

Later in 1933, Eccles's perseverance and constructive criticism finally landed him a meeting in Washington, D.C., with key New Dealers, including Rexford Tugwell, a close adviser to President Roosevelt. During a series of meetings with Tugwell, Eccles repeated his arguments for government-planned deficit financing. At the end of his visit, Tugwell raised the possibility of Eccles joining the administration in Washington. Eccles, however, was reluctant to accept, and the two parted without reaching a firm commitment. But by the end of the year, Eccles had received a telegram from the Treasury department asking if he would come to Washington to discuss certain monetary matters with the new acting secretary of the treasury, Henry Morgenthau Jr.

After a string of new meetings in Washington, Eccles was finally convinced to turn his words to action. And so, starting February 1, 1934, Marriner Eccles, the millionaire industrialist from Utah, was appointed assistant to the secretary of the treasury with a salary of \$10,000 per annum. Initially, Morgenthau asked him to review the human resource situation of the Treasury department, but soon Eccles was busy with key monetary and banking legislation. This included the new National Housing Act that would establish the Federal Housing Administration and revolutionize housing finance in the United States.

Eccles's assignment in the Treasury was meant to last only one year, but later that year the governor of the Federal Reserve Board resigned and the administration began looking for a replacement. Eccles was one of the candidates considered, but when the president asked if he was interested, Eccles politely rejected the offer.⁸⁰ He told the president that private banking interests, particularly from the large New York banks, currently dominated the Board. The Board was therefore not in a position to impose public control on monetary policy. Though the Board could suggest open market operations, regional banks could decide to simply ignore the "suggestion" (Hyman 1976, p. 155).

⁸⁰ Eccles told the president that he "would not touch the position of Governor with a ten-foot pole unless fundamental changes were made to the Federal Reserve System" (Hyman 1976, p. 155).

But Eccles added that if Roosevelt would support changes to the Federal Reserve System, then he would “welcome any consideration you might give to my personal fitness to serve as governor of the Federal Reserve Board” (Hyman 1976, p. 155). The president was intrigued by this unconventional reaction and asked Eccles which specific changes he had in mind. Eccles asked for some time, and went back to work on a proposal for a radical overhaul of the Federal Reserve System. In a meeting with the president on November 4, he brought with him a memorandum, prepared with the help of his assistant Lauchlin Currie,⁸¹ titled “Desirable Changes in the Administration of the Federal Reserve System” (Currie 2004 [1934]). This was to form the backbone of Title II of the new Banking Act of 1935, which would create a new and more accountable Federal Reserve System.⁸²

A. Agitation for central banking

The memorandum argued that the monetary system should be used to promote business stability. Experience had shown that without public control, the money supply tended to expand in booms and contract in depressions. According to the memo, production, employment, and national income were determined by the available supply of cash and deposits, and the supply should be adjusted to achieve the desired level of income and employment.

The memorandum further argued that the Federal Reserve Board’s centralized control of monetary policy should be increased. It argued that the Board should be given complete control over the timing, character, and volume of open market operations, and that regional governors should be appointed annually and be subject to approval from the Federal Reserve Board.

These changes were necessary in order to give the Board full control of open market operations, since such policy decisions at the time included hundreds of people at the regional level. The reform proposed by Currie and Eccles would instead concentrate the authority and responsibility for monetary policy in Washington, D.C.:

These suggestions would “introduce certain attributes of a real central bank capable of energetic and positive action without calling for a drastic revision of the whole Federal Reserve Act. Private ownership [of the regional Reserve Banks] and local autonomy are preserved,” but on really important issues of

⁸¹ Currie was a Canadian economist, trained at the London School of Economics and Harvard University. He was an early advocate of government deficit financing during the Great Depression and went on to become Eccles’s assistant at the Federal Reserve Board, and later the first economist in the White House, a job that would become part of the Council of Economic Advisers.

⁸² FDR shrewdly combined the proposal for reforming the Federal Reserve System (in Title II of the Act)—which would not easily pass in Congress—with two other proposals that both bankers and Congress favored. Title I amended the permanent deposit insurance provisions of the Banking Act of 1933, while Title III mostly consisted of technical amendments. Both Titles I and III were eagerly awaited by the banking community, with a deadline of July 1 putting pressure on the legislative process in Congress.

policy authority and responsibility, they would be transferred to the Board.
(Currie 2004 [1934], p. 269)

For two full hours Eccles explained his memorandum to an attentive President Roosevelt. Finally, the president slapped his powerful hands down on the table in his characteristic gesture of decision and said, “Marriner, that’s quite an action program you want. It will be a knock-down and drag-out fight to get it through. But we might as well undertake it now as at any other time.”⁸³

By agreeing to this proposal, Roosevelt accepted the creation of a central monetary authority. The plan sought to centralize control in Washington—away from the banking-dominated Reserve Bank of New York—and to move the Federal Reserve closer to the Treasury. But some of the changes later made by Congress also made the Fed more independent of the administration, thereby creating the potential for future conflicts between these two “strong-willed” institutions.⁸⁴

B. Public control of money

Since time immemorial, the power to coin money and regulate its value has been an attribute of sovereign power. With the development of deposit banking, however, private banks gained the power to create and destroy money by making loans, regardless of the consequences for the economy as a whole. Eccles wanted to reestablish the primacy of the State in monetary affairs, and to bring the issuance of money under democratic control. By centralizing power with the Federal Reserve Board, its status would be enhanced. The new Board would implement monetary policy with the intent to influence the behavior of private banks, so as to counteract their procyclical behavior. For this to succeed, Eccles needed to shift power from the regional Reserve Banks to the center of the System. And the Banking Act was the vehicle for this “grand reform” (Currie 2004 [1934], p. 4):

A policy of laissez faire in banking presupposes an economy possessing a flexibility that I think it is hopeless for us to expect to achieve. Therefore it is absolutely essential to develop agencies that by conscious and deliberate compensatory action will obviate the necessity of drastic downward or upward adjustments of costs and prices, wages and capital structures. If we do not develop such agencies, our present economy, and perhaps even our present form of government, cannot long survive. (Eccles 1935a, p. 9)

Eccles’s adviser, Lauchlin Currie, provided more arguments for Title II of the Banking Bill in a speech he gave in Philadelphia. This was obviously required, he noted, since many viewed

⁸³ Quoted in Eccles 1951, p. 138

⁸⁴ Meltzer (2003, p. 484) notes that Morgenthau supported the bill to get an ally in financing the government’s budget deficits. He wrote in his diary: “I have been hoping and have not mentioned it to a soul that the Federal Reserve would be given additional powers . . . so that they and the Treasury can share the responsibility and possibly help us in case we get into a financial jam.”

the bill “as a sinister plot on the part of the Administration to capture and wreck the banking system in the pursuit of its own unworthy purposes” (Currie 2004 [1935], p. 281). This, according to Currie, was a grave misrepresentation of their position.

According to Currie, the key goal of Title II was to establish a small and flexible monetary authority with powers to counter-cyclically vary the money supply and thereby secure business stability. Currie went on to argue that the central bank’s power to conduct monetary policy should not be constrained by the particular type of loans banks might happen to have. In his view, “the primary function of banks is that of supplying money and not of meeting requirements of business for any particular type of loan” (Currie 2004 [1935], p. 281).⁸⁵

The new monetary authority would not be subsumed under the administration in its conduct of monetary policy, but would have to cooperate with the administration in order to achieve its monetary objectives. But, in the current situation, “it is highly questionable whether business stability can be achieved through monetary means alone” (Currie 2004 [1935], p. 282). Fiscal policy would therefore be the prime instrument to get the economy back on track, according to Currie.

He added that the Federal Reserve System should be more than just a provider of seasonal and emergency loans (as provided for in the original Federal Reserve Act of 1913). The Board would not merely conduct credit policy, but rather would oversee monetary policy. “This change in emphasis is absolutely vital to understanding the bill” (Currie 2004 [1935], p. 282). However, responsibility for credit administration and banking supervision would be delegated to the regional Reserve Banks.

He then addressed the “highly controversial question of the relation of monetary authority to the Government.” Congress possessed the constitutional power to coin money and to regulate the value thereof, but for administrative purposes in the 20th century, it seemed obvious that this power should be delegated. The question was, to whom?

The Federal Reserve is a creation of Congress and not of the Constitution, and its duty is to carry out the will of Congress. It is necessary, therefore, that Congress retain some degree of control over the money issuing authority. The people must have some way, even though it is remote, of expressing their satisfaction or dissatisfaction with the manner in which the delegated powers of money control are being exercised. (Currie 2004 [1935], p. 286)

But it was also important to establish some separation between monetary policy and the daily vicissitudes of politics. Currie favored a system in which the president would appoint Board members, but one in which those Board members would be expected to act

⁸⁵ This was in reference to the prevailing policy of only discounting “real bills”; that is, providing funds to banks secured with business loans. The idea was that this would somehow reduce the extent of speculative lending; see Meltzer (2003), pp. 485–86.

relatively independently. To strengthen their position, the bill provided for long terms (12 years), increased salaries, and pensions for Board members;⁸⁶ required greater professional qualifications for Board members; and set an explicit objective for monetary policy.⁸⁷

But “the best safeguard against manipulation of monetary policy for partisan purposes would be full publicity and widespread awareness of the importance and significance of Federal Reserve policies.”⁸⁸ With increased popular awareness of the importance of the Federal Reserve, and with the full light of publicity turned on its every action, Currie “did not think any Administration would dare to exert pressure on the board to pursue policies on political grounds” (Currie 2004 [1935], p. 286).

He concluded by urging Congress to rapidly pass the bill, which would bring forward “a unified and responsive monetary system where deposits are as safe as currency, where the [policy] instruments are so good as to make compensatory monetary policy action possible, and where the controlling body will cooperate with the Government and yet be free from political domination in the bad sense of the term” (Currie 2004 [1935], p. 288).

C. Collateral policy and liquidity support

By relaxing the collateral requirements for rediscounting at the Federal Reserve, Eccles and Currie hoped to induce banks to lend more, and to lend with longer maturities. Broader eligibility criteria would enable Federal Reserve Banks to check the contraction and to make secured loans to member banks—if necessary, collateralized by secure illiquid assets. As Currie noted, “Banks must make longer-term loans to justify their existence” (Currie 2004 [1935], p. 285).

The change in collateral policy would also enable the Federal Reserve to act more forcefully in a crisis. “One of the most disastrous developments in the whole depression was the scramble for liquidity on the part of thousands of individual banks and by their very scramble effectively precluding the possibility of liquidity” (Currie 2004 [1935], p. 285). The Fed had been restricted by the tight collateral requirements in 1931, when banks experienced a shortage of eligible paper. As a consequence, the Federal Reserve could not increase market liquidity and was unable to counteract the rapid contraction of deposits.

The Glass-Steagall Act of 1932 had temporarily enabled the Federal Reserve to use government securities from open market operations as collateral for Federal Reserve notes. Now Eccles suggested that “it was realistic and desirable to do away with the collateral requirements [for notes] altogether” (Eccles 1935a, p. 7). But this did not mean that notes would be issued without adequate backing. Any increase in note issuance would

⁸⁶ From \$12,000 to \$15,000 per annum.

⁸⁷ However, the proposal for a new policy objective was not accepted by Congress.

⁸⁸ Note today’s emphasis on “transparency” and “accountability.”

be counterbalanced by a corresponding increase in Federal Reserve Bank assets. But there was no need to limit the discounting to purely short-term commercial bills. This change in policy, Eccles noted, would greatly enhance the System's ability to buy securities, to get member banks out of debt, and thus to ultimately stem the process of deflation (Eccles 1935a, p. 7).

By removing the problem of liquidity from the concern of individual banks, and by making all sound assets eligible for discounting with the Reserve Banks, "the banks could concentrate their efforts on keeping their assets sound and pay less attention to their form and maturity" (Eccles 1935a, p. 9). And Eccles noted that the amount of borrowing from the Fed would be limited by the general rediscount policy, as well as by the "unwritten law that borrowing should not be continuous and should be for emergency and seasonal purposes only" (Eccles 1935a, p. 7).

By extending the eligibility criteria for rediscounting, "the problem of liquidity shall cease to be an individual concern and shall become the collective concern of the banking system" (Eccles 1935a, p. 9). As Eccles noted when he presented the Bill in Congress: "The proposals in this bill are simple and concrete; without modifying the essential nature of the Federal Reserve System, they strengthen its power to meet future emergencies and increase the ability of member banks to facilitate recovery" (US Congress 1935, p. 299).

D. The fight in Congress

The passage of the Banking Act was by no means assured, as President Roosevelt had warned. Senator Glass was in a bad mood after Eccles failed to provide him with an advance copy of the bill. Glass—the "father" of the Federal Reserve Act of 1913—had been President Woodrow Wilson's secretary of the treasury, and the most senior member on the Senate Committee on Banking and Currency. He did not look favorably upon Eccles's attempt to reform the Federal Reserve, and hoped to ensure the bill's defeat. Glass enlisted the big banks—most of which feared greater political control of the Federal Reserve, deficit financing, and the loss of private control of open market operations—in the campaign against the bill.

Winthrop W. Aldrich, the chairman of the Chase National Bank of the City of New York, expressed the fears of many bankers when he noted that the administration could use the system "for the purpose of creating a boom at the time when an election approaches" and by warning that the Treasury could use "the Reserve banks as a means of finance" (Weldin 2000, p. 65).⁸⁹

The bankers' resistance to the bill heightened Eccles's concern that the banks might block the administration's plans for large-scale public works. Glass calculated that the Federal Reserve would have to absorb a large part of the securities needed to finance such works,

⁸⁹ He was the son of Senator Nelson Aldrich (1841–1915), who was one of the main architects of the 1913 Federal Reserve Act.

but with private banks in control of the regional Reserve Banks, this source of financing could easily be blocked (Hyman 1976, p. 165). The passage of the bill therefore became all the more urgent and critical.

After the bill's initial hearing in the House of Representatives, it became evident that passage in the House would be easier than passage in the Senate. Senator Glass delayed Eccles's hearing before the Committee on Banking and Currency for days, producing all sorts of excuses. When Eccles finally appeared before the committee, he tried to downplay the radical nature of the bill, stressing that "there is nothing in this bill that would increase the powers of a political administration over the Reserve Board" (US Congress 1935, p. 280). But, as he noted, the bill would strengthen "the public control of the function of supplying the medium of exchange to the people of the United States, both by issuing currency and by regulating the volume of bank deposits." Eccles argued that this ought not be controversial:

It is in direct recognition of the constitutional requirement that Congress shall coin money and regulate the value thereof. In delegating this power Congress has chosen, and, in my opinion, always will choose, to delegate it, not to private interests but to a Government body like the Federal Reserve Board, created by Congress to serve as its own agency in discharging its responsibility for monetary control. (US Congress 1935, p. 281)

But he also noted that "the Federal Reserve could not work at cross-purposes with the Government, particularly at times of emergency. Since central banking institutions derive their power from the Government—are, in fact, creatures of the Government—there must be cooperation between the Government, which determines economic policies, and the bank of issue which determines monetary policies" (US Congress 1935, p. 284).

In the House of Representatives, the bill was aggressively championed by representatives Steagall and Goldsborough, and was approved on May 9 by a lopsided vote of 271 to 110.⁹⁰ But in the Senate, Glass continued his endless delaying tactics.⁹¹ It was only after direct intervention by President Roosevelt, and nearly two months after the House had adopted the bill, that the Senate belatedly passed its version of the bill on overtime, on July 2. According to Eccles, "It was woefully inadequate and a world apart from the aggressive version that had passed the House of Representatives" (US Congress 1935, p. 219). But it was still better than nothing.

When President Roosevelt finally signed the Banking Act of 1935, the press portrayed it as "Senator Glass Wins Victory," and the senator himself gloated by saying, "We did not leave

⁹⁰ Eccles noted: "It was no exaggeration to say that had it not been for Steagall and Goldsborough, the whole attempt to revitalize the Reserve system should have been killed off by the very men who first gave it life" (Eccles 1951a, p. 181).

⁹¹ Glass had tried in vain to block the appointment of Eccles as Federal Reserve chairman. Indeed, he had almost succeeded, but some last-minute chance encounters shifted opinion among some members of the committee, and Eccles was confirmed on April 25 (Eccles 1951a, p. 204).

enough of the Eccles bill with which to light a cigarette" (Phillips 1995, p. 127). But Eccles was sufficiently satisfied with the new Act and noted that the Federal Reserve Board had wrested firm and formal control of monetary policy from the regional Reserve Banks, including the setting of reserve requirements and the formulation of open market policies.⁹²

II. War Financing and Inflation Fears

In September 1938, the presidents of the Federal Reserve Banks met to consider options for wartime policy. They agreed that it was important to stabilize government securities markets and to avoid the problem of rising interest rates as investors deferred purchases of bonds in anticipation of still higher rates (Eichengreen and Garber 1991, p. 180). Early in 1938, the Federal Open Market Committee (FOMC) was authorized to buy government securities to prevent their prices from falling (i.e., rates from increasing). This was a continuation of the low-interest policy of the 1930s, but now in a more formalized way.

A. War financing: The peg

After the US entered the war, the Federal Reserve System agreed in March 1942 to fix the rates on Treasury bills at $\frac{3}{8}$ percent and to fix the rates on long-term bonds at $2\frac{1}{2}$ percent. The long-term rate would remain at this level for nine years, until the Accord was reached in March 1951. The Reserve Banks purchased all securities offered to them at these prices to prevent interest rate increases.⁹³

The agreed yield curve reflected market rates as of March 1942. But soon afterward, the newly "guaranteed" rates led to massive rebalancing of private portfolios from short- to long-term securities. Investors sold bills for higher yielding bonds, forcing the Fed to do accommodate in order to maintain the pegged rates. By the end of the war, the Federal Reserve System held virtually the entire supply of Treasury bills (Eichengreen and Garber 1991, p. 181). "Bills ceased to be a market instrument" (Eccles 1951a, p. 359).

Banks offered their customers cheap finance to purchase bonds during the Treasury's war bond campaigns, only to buy back the bonds afterward. Though the Treasury officially opposed this profitable scheme, it did little to prevent banks from doing it. As a result, nonbank purchases during the war amounted to some \$147 billion, but since a large share

⁹² During passage in Congress, the previous practice of representation on the Federal Reserve Board by the Treasury and FDIC was discontinued. This certainly strengthened the Board's independence.

⁹³ According to Meltzer (2003, p. 594), the Treasury was not initially interested in an explicit peg. They asked the System to keep large reserves in the market, preferably by reducing reserve requirements. When the Fed objected, the Treasury then proposed the $\frac{3}{8}$ percent rate. The Fed concurred in March to support "the pattern of (low) interest rates" and "the general market to be maintained on about the present curve of rates." Eichengreen and Garber (1991, p. 180n8) argue that there was only an informal agreement on the bond rate of $2\frac{1}{2}$ percent, although there was no convincing explanation of the decision to settle on just that rate. Britain had pegged consoles at 3 percent, and US officials argued that superior US credit justified a lower rate. Eccles and the Board thought the rate had been set too low (Hyman 1976, p. 283).

of the bonds were sold back to the banks, the nonbank sector was only left with a balance of \$93 billion by the end of the war (Meltzer 2003, p. 591). And as Meltzer noted, “The result of the war financing was very different from the founders [of the Federal Reserve’s] plan; the System had [by then] become an indirect source of government finance” (Meltzer 2003, p. 598). It would soon become a direct source of finance as well.

In March 1942, the Second War Powers Act authorized Federal Reserve Banks to acquire US government securities directly from the Treasury. Eccles informed the Board about the decision to include this in the bill after a meeting with President Roosevelt. As a result, section 14(b) of the Federal Reserve Act had to be changed.⁹⁴ But Eccles added that “the use of the new power would arise only in exceptional circumstances as, for instance, in a situation where a Treasury issue temporarily could not be sold and the Treasury was in need of funds, in which case the Federal Reserve Banks would take the issue and resell it to the market” (BGFRS 1942, p. 3).

Eccles noted that extraordinary times required extraordinary measures. Any attempt by the System to assert its independence and oppose the new policy “would result in the loss of authority and influence that it otherwise might have.” In the context of total war, it would be a mistake for the central bank to regard itself as being completely independent, and “the kind of independence a central bank should have was an opportunity to express its views in connection with the determination of policy, and that after it had been heard it should not try to make its will prevail, but should cooperate in carrying out the program agreed upon by the Government” (BGFRS 1942, p. 8). Eccles’s rather servile interpretation of central bank independence must have been influenced by the war situation, and his views would gradually evolve as the war ended and the potential for postwar inflation became a more imminent concern. This highlights, once again, the importance of considering historical context in understanding Eccles’s view of central bank independence.

As indicated by Eccles, the changes in operating procedures were indeed quite revolutionary, and were not simply technical operational changes.⁹⁵ The new policy would stay in place long after the war had ended. The War Powers Act was set to expire after the war ended, but the Board requested renewal for two more years, and later the authority became permanent (Meltzer 2003, p. 599). This permitted the Treasury to continue to borrow limited amounts directly from the Federal Reserve. Beginning in 1979, the length of such loans and other conditions related to the use of the facility were restricted, and in 1981 the authority for such direct loans to the Treasury was revoked permanently (Meulendyke 1989, p. 152n2).

⁹⁴ Section 14(b) of the Federal Reserve Act contained the prohibition against the purchase by the Federal Reserve Banks of direct and guaranteed obligations of the United States other than in the open market (BGFRS 1942, p. 2).

⁹⁵ Indeed, the question of whether or not central banks should make direct purchases of government paper is central to the current debate in the euro area of how to solve the ongoing financial crisis.

B. Monetary policy locked to the peg

Eccles was reluctant to move against the Treasury. He noted that the System had “adequate powers to stop a further bank credit inflation right in its tracks, but to do so they would have had to withdraw support for the Government market” (Eccles 1948, p. 12). And the Board was also concerned about the impact on the bond market and on financial stability more broadly if it were to increase its discount rate:⁹⁶

Certainly if we should do what some people ask us to do, that is, use the traditional authority of the Federal Reserve System, withdraw from the Government bond market, let interest rates go up as the means of stopping credit expansion, let them go so high that people just won't borrow, or let them go so high that you certainly would stop inflation—where would the cost of carrying the public debt go if you pursued that policy? (Eccles 1948, p. 16)

He noted that around 60 percent of the public debt (of \$250 billion) was held by the banking system and that an increase in the long rate would have a negative impact on their balance sheets. Thus, “the debt must be managed and the long term rate [the 2½ percent rate] must be protected” (Eccles 1948, p. 12). An increase in the rates would also increase bank earnings, which were already very high, and further act as a disincentive for banks to lend to the rest of the private sector (Eccles 1946, p. 2). Therefore, concluded Eccles, “to raise the discount rate was purely academic and would not be effective anyway” (Eccles 1948, p. 13).⁹⁷

Eccles also wanted to maintain cordial relations with Treasury Secretary Morgenthau, although this proved difficult during the war. Eccles and Morgenthau tussled in numerous skirmishes, because while the Treasury was bent on selling bonds at low rates to finance the war effort, the Federal Reserve was becoming increasingly concerned with the extent of bank financing.⁹⁸ The two men's relationship was still colored by the situation in the 1930s when the Fed's ability to conduct open market operations had been limited by its small holding of government securities, and when the Treasury had threatened to use its Exchange Stabilization Fund and other Treasury accounts to bring the Fed in line with its policy wishes (Meltzer 2003, pp. 484, 634). During the war, Treasury officials would frequently call on Federal Reserve Board members to remind them of their commitment to the war financing effort and to check on progress (Hyman 1976, p. 284). President Roosevelt had issued a directive to his Cabinet (dated July 15, 1943) to sort out policy differences without going public and especially not involving the press (Hyman 1976, p. 300). Eccles respected the president's “ban against public controversy within the

⁹⁶ Many of the key policymakers at the time still had living memories of the sharp fall in government bond prices after World War I, when a sharp increase in rates to protect the dollar had wiped out over 20 percent of the bond market.

⁹⁷ He added that as long as the Federal Reserve supported the bond market, it provided money for the banks to lend. “Under these circumstances to raise the discount rate is meaningless” (Eccles 1948, p. 13).

⁹⁸ See Hyman (1976, p. 293) for more details.

administration,” but relations with Treasury remained tense (Hyman 1976, p. 305). The Treasury preferred low rates, while the Board wanted more flexibility in setting rates. Thus, there was a deadlock on the issue of changing rates.

C. The Fed is reluctant to act

Hamstrung and unable to use its main policy instruments, the Federal Reserve pressured Congress for supplementary powers. It repeated these demands in its annual reports in 1946, 1947, and 1948 without eliciting much reaction from Congress and without gaining the administration’s approval (Eccles 1951a, p. 426). So, while Eccles desired to reestablish the Federal Reserve’s core monetary function (Eccles 1946, p. 14), he also remained committed to protecting the long-term rate of 2½ percent.⁹⁹ As a result, the Federal Reserve’s balance sheet ended up acting as a buffer stock, absorbing all the debt that others were unwilling to hold at the given yield pattern (Chandler 1949, p. 419).

The Board then looked for other ways to restrict credit. In January 1946, the Federal Reserve increased margin requirements to 100 percent in an effort to curb speculative trading on Wall Street, and continued to explore the possibility of using other administrative measures such as special reserve requirements, loan reserves, and even voluntary guidelines.¹⁰⁰ But Eccles recognized that voluntary restraints would have limited effects, and so he continued to press Congress for supplementary powers.

D. Inflationary pressures

When the war ended, many members of Congress favored removing all wartime price and wage controls straight away. At first the administration was hesitant and extended some of the controls, but eventually gave in. In an attempt to prevent prices from increasing, fiscal policy was tightened, but this effect was nullified by strong credit growth by the banking system. Strong inflationary pressures resulted; US wholesale prices rose by 25 percent on a yearly basis (Eichengreen and Garber 1991, p. 183).

Eccles and the Board opposed terminating wage and price controls, and also opposed prematurely repealing the excess profit tax in 1945 (Meltzer 2003, p. 608). Eccles argued that “when the war is over, it should be apparent to everyone that the need of controls is much greater, if anything, than during the war” (Eccles 1948, p. 5). He felt that the government did not adequately appreciate the seriousness of “the inflation problem.” It would have been much better to retain the controls and delay tax reductions “until such time as supply was more nearly in balance with demand” (Eccles 1951a, p. 411). The net

⁹⁹ “The one thing you cannot do is to have confidence shaken in that 2½ percent rate. If you let that go below par, there is always a question, where does it go? Because people remember, a great many of them, what happened after the last war when they let those securities go below par” (Eccles 1947, p. 620).

¹⁰⁰ Eccles agreed that the effect on inflation of increasing the margin requirement would be minor, and suggested that the speculative activity could better be addressed by an adequate capital gains tax (BGFERS 1946, p. 2).

result of removing “all the essential harness of controls” was more inflation after the war than during the war: “The real inflation was not from 1940 to 1945; the real inflation came within the past two years with the taking off of the controls prematurely” (Eccles 1948, p. 7).

Eccles raised the issue several times with Treasury Secretary Vinson, but the response was always the same: “The proposal would increase the already large interest charge on the public debt” (Eccles 1951a, p. 423). Eccles explained that the Federal Reserve had a mandate from Congress to control inflation, and that the current policy of pegged rates added to inflationary pressures. But the Treasury remained firmly committed to “the philosophy of low and lower rates of interest; that low rates have little effect on inflation, and that inflation has to be dealt with by direct, rather than monetary measures” (Eccles 1949b, p. 5). The Treasury accused the Federal Reserve of “staging a sit-down strike by refusing to carry out Treasury Policy,” while Eccles noted that “if we carried out Treasury policy we would default on our obligations to Congress in the field of money and credit” (Eccles 1951a, p. 424).

As a result, interest rates remained low, prices continued to rise, and, finally, in the fall of 1947, President Truman called for a special session of Congress to restore wage and price controls. Congress rejected Truman’s proposal, and instead authorized the Federal Reserve to control consumer credit and installment loans in an attempt to curb the very rapid growth in credit from the banking sector.

Then, in 1948, a brief recession led to a respite from inflation. But with the return of expansion and inflation again by early 1950, Alan Sproul of the Federal Reserve Bank of New York pressed hard for a firmer Board policy, to give “a signal to the whole financial community and to the public that there has been a change in our policy in light of the changed business and credit situation” (Meltzer 2003, p. 682). He was willing to confront the Treasury by increasing the short rates and, if need be, by letting long-term bonds fall below par (i.e., let their rates go above 2.5 percent). Eccles gave Sproul limited support. He did not think the market was sufficiently flexible yet to permit substantial fluctuations in the prices of long-term bonds. Other members feared that “a large Treasury issue under these conditions might set off an over-rapid readjustment in the corporate bond market with undesirable effects on business psychology” (BGFRS 1950a, p. 7). The issue remained unresolved, and Treasury Secretary Snyder refused to raise the offering rates on new issues. Because the System was not prepared to let the new issues fail, it had no choice but to purchase heavily, offsetting part of the purchases with sales of bills. “So in this way the first real skirmish between the Fed and the Treasury ended with the System supporting the rates set by the Treasury” (Meltzer 2003, p. 683).

III. The 1951 Treasury – Federal Reserve Accord

A. The battle of the peg

The Treasury – Federal Reserve debate over monetary policy has been characterized as “a violent conflict” (Sproul in BGFRS 1951b, p. 9), “a struggle” (Tobin 1950, p. 118), “a confrontation” (Hetzel and Leach 2001, p. 4), “a war” (Timberlake 1999, p. 6), and “a dispute” (Eccles 1951c, p. 1). Sproul later dismissed the association with “a battle that the Federal Reserve won,” since “the System may have won a battle, but Governments always win the wars” (US Congress 1952a, p. 535). He noted that there had been a “difference of opinion between the Treasury and the Federal Reserve System, both of them representing the Government, and you can call it a triumph of reason, if you want to, but not the winning of a battle” (US Congress 1952a, p. 535).

Internally, the Board also deemphasized the degree of discord and controversy, noting that “difference of opinion between the Treasury and the Federal Reserve over interest rates does not seem to be of epic dimensions” (BGFRS 1951c, p. 14). Still, many still consider this event “the greatest political battle in the history of central banking,” and the “battle of the peg” was certainly marked by all the ingredients of a Shakespearean drama: early skirmishes, diversions, parading, attempts to win over public opinion, and stubborn and strong-willed actors. Of particular interest is the evolution of views on monetary policy during this period among the key Federal Reserve actors, including Eccles, especially regarding the need for a more flexible interest policy.¹⁰¹

But as Meltzer notes, “The accord was not inevitable. The Truman Administration could have appealed to patriotism, to the exigencies of war and to populist sentiment against higher interest rates to keep the support program in place” (Meltzer 2003, p. 712). But four factors worked to the benefit of the System’s position. First, it found support within the administration. Second, the financial press took its side. Third, opinion in the Senate shifted toward a more independent policy, and inflation rose rapidly (Meltzer 2003, p. 702). In the end, the System prevailed and “a new era of central banking” would begin (BGFRS 1951e, p. 12).

B. The Douglas report

The ongoing Treasury – Federal Reserve tensions led Congress to appoint “the Douglas Committee” in 1949 to study the “Monetary, Credit, and Fiscal Policies” of the United States. Senator Paul Douglas had been a professor of economics at the University of Chicago and was elected to the US Senate in 1949 as a Democrat. As chair of the subcommittee, he conducted the hearings during 1949 with considerable skill, and Douglas’s report did

¹⁰¹ Eccles favored fiscal policy to stabilize the economy and control inflation. But with inflationary pressures building after the onset of the Korean War and Congress reluctant to grant further administrative powers to control reserves, he gradually came to believe that a more flexible interest policy was required (Hetzel and Leach 2001, p. 37n8).

played an important role in changing the political balance in Congress in favor of the Federal Reserve (Meltzer 2003, p. 582).

A key concern for the committee was coordination between fiscal policy and monetary policy. As Senator Douglas noted:

This is something that puzzles me a bit: As I remember it, the Federal Reserve System was supposed to be an independent agency; the Treasury, another independent agency. Yet, it is inevitable that the views of one be taken into consideration by the other, and highly desirable. What is the machinery for coordinating the policies of the Reserve System with the policies of the Treasury? (Quoted in Eccles 1949c, pp. 230–31)

Eccles only cautiously supported central bank independence at this stage. The Federal Reserve should give advice to the Treasury and Congress, but “not enforce its will”: “Any open-market committee, or any central banking system, that for any length of time did not go along with that conception [of independence] would not survive” (Eccles 1949c, p. 231). He noted that no other central bank “has ever successfully used its authority to enforce the will over any administration in power” (Eccles 1949c, p. 237).¹⁰²

But Eccles supported Senator Douglas’s idea of instructing the Treasury in its debt management policies and its procedures of cooperation with the Federal Reserve System (Eccles 1949c, p. 235). He also noted that the Treasury had a persistent (cheap) money bias, which made it difficult for the Fed to ever raise rates. The Treasury did not see the need for rate increases, since they “continued to brush aside or depreciate the influence of interest rate changes on the availability of credit” (Eccles 1949b, p. 13).

In a supplementary letter to Senator Douglas, Eccles added that the size of the postwar government debt had complicated the conduct of monetary policy. As the size of the public debt grew, the needs of the Treasury for cheap financing became dominant. He noted that when “the Treasury announces the issue of securities at a very low rate pattern during a period of credit expansion, . . . the Federal Reserve is forced to defend these terms unless the System is prepared to let the financing fail, which it could not very well do” (Eccles 1949a, p. 7). Under these conditions, it could hardly be said that Federal Reserve was free to set its own independent monetary policy.

Eccles therefore urged Congress to more clearly define the respective roles of the Treasury and the Federal Reserve, and to “direct the Treasury to consult with the System in the formulation of its debt-management decisions in order that these decisions may be compatible with the general framework of credit and monetary policy being followed by the System in the interest of general economic stability” (Eccles 1949a, p. 9; Eccles 1949b,

¹⁰² Meltzer (2003, p. 689) notes that Chairman William McChesney Martin Jr. also shared this view during the 1950s and 1960s.

p. 13). Without such guidelines, the Federal Reserve System would be altogether subordinated the Treasury (Eccles 1949b, p. 13).¹⁰³

When Senator Douglas appeared on the Senate floor to defend the report, he observed initially that:¹⁰⁴

The so-called controversy between the Treasury and the Federal Reserve System must be utterly baffling to the general public. As a writer in *Fortune Magazine* put it, it seems like a battle between two adding machines. Yet, next to defense, it is by far the most important question we face today. (BGFRS 1951c, p. 1)

Senator Douglas noted that as long as the Federal Reserve remained “the residual buyer of Government securities,” every security the Federal Reserve buys would add to bank reserves, or “high-powered money” that would support further bank lending. “This is the royal road to inflation” (BGFRS 1951c, p. 10). Douglas argued that pegging of the rate structure should not be allowed to persist forever. But despite the strong positions taken by both agencies in the hearings, Douglas perceived that there could be “a meeting of minds” (BGFRS 1951c, p. 14). The Federal Reserve System needed to be freed from “support operations which continue week in and week out to feed high-powered dollars in the market where inflationary pressures are rampant and where bank loans alone have gone up by 10 billion dollars since Korea” (BGFRS 1951c, p. 15). In order to avoid inflation, it was essential that the Federal Reserve could restrict credit and raise interest rates “even if the cost should prove to be a significant increase in service charges on the Federal debt” (BGFRS 1951c, p. 16).

The report supported his views, and concluded that:

It is the will of Congress that the primary power and responsibility for regulating the supply, availability, and cost of credit in general shall be vested in the duly constituted authorities of the Federal Reserve System, and that Treasury action relative to money, credit, and transactions in the Federal debt shall be made consistent with the policies of the Federal Reserve. (US Congress 1950, p. 31)

This “Douglas resolution” asserted the Federal Reserve Board’s primacy in open market operations and credit policies, and directed the Treasury to adjust its debt management

¹⁰³ While Eccles favored “coordinated independence” for the Federal Reserve at the time of the hearing, he strongly opposed the idea of submerging the credit and monetary functions of the Fed in the Treasury, like “a division or a department of monetary and credit control.” “This may well lead, in time to a socialization of the credit structure, which, I think, would be very undesirable and very dangerous” (Eccles 1949, pp. 237, 243, respectively).

¹⁰⁴ Senator Douglas had been provided with extensive notes from the Board of Governors before his Senate appearance: “Material furnished Senator Douglas by the Board on February 26, 1951. Used by Senator Douglas in his statement of February 22 on the Floor of the Senate” (BGFRS 1951c).

policy in the light of the Federal Reserve's monetary policy (US Congress 1949, p. 390). Thus, the committee supported the view that interest rates should be determined by monetary authorities rather than by fiscal authorities (Goldenweiser 1950, p. 390).

The subcommittee's report helped shift public opinion in favor of the Federal Reserve's point of view. Even though the instructions and new mandates proposed by the committee were never passed, the report likely stiffened the Federal Reserve's resolve in the subsequent conflict with the Treasury (Tobin 1953, p. 119).¹⁰⁵ Eccles also noted that congressional support during the hearings helped the Federal Reserve to regain its independence (Meltzer 2003, p. 685n184).

C. The Korean War

The other event that changed the Treasury–Fed balance was the start of the Korean War (Meltzer 2003, p. 582). With the outbreak of war, there was an urgent need to once again switch US production from civilian to military uses. Expectations of shortages and possible rationing led to sharp price increases, and wholesale prices increased by 17 percent between June and December 1950 (Hyman 1976, p. 341). With upward pressures on interest rates as well, System purchases of Treasury securities continued at an accelerating pace.

With the government budget nearly balanced, it seemed to be primarily the growth in private credit that required reining in: “To prevent inflation we must stop the overall growth in credit and the money supply whether for financing Government or private deficit spending. The supply of money must be controlled at the source of its creation, which is the banking system” (Eccles 1951b, p. 4). Eccles argued that if required, interest rates should be allowed to go higher by withdrawing Federal Reserve support from the government securities market and penalizing borrowing by member banks from the System. A continuation of the current policy of a “frozen pattern of interest rates” would be highly problematic.

The outbreak of the Korean War shifted Truman's priorities; he could not fight two wars at the same time. With his attention occupied by more pressing matters, Truman almost certainly felt that infighting between the Treasury and the Federal Reserve was of lesser importance. So he left it to the Treasury and the Federal Reserve to sort out their differences amongst themselves. But further internecine feuding was on the docket before the final Accord would be signed. In late 1950, the conflict between the Federal Reserve and the Treasury intensified and became quite public (Meltzer 2003, p. 699). With

¹⁰⁵ Sproul observed during the Patman hearings in 1952 that “the Accord was reached after it became clear that the Federal Reserve had a considerable support in the Congress and among the public for requesting and demanding equal powers and equal consideration in the determination of these questions of credit policy and debt management where they overlapped” (US Congress 1952a, p. 535).

inflationary pressures mounting, the Federal Reserve Board's patience with the Treasury's foot dragging was about to come to an abrupt end.

D. FOMC announces higher short-term rates

At the August 18 FOMC Meeting, New York Fed President Sproul voiced his support for a more flexible rate policy and noted that the Treasury was unwilling to sop up available nonbank funds by issuing long-term securities. He stated that the issue was neither the long-term bond rate nor the refunding of September–October maturities, but was rather “what we are going to do about making further reserve funds available to the banking system in a dangerously inflationary situation” (BGFRS 1950b, p. 10). Sproul ruled out “drastic credit measures,” but added that they had “marched up the hill and then marched down again” too many times without convincing the Treasury of rate changes. “This time I think we should act on the basis of our unwillingness to continue to supply reserves to the market by supporting the existing rate structure and we should advise the Treasury that this is what we intend to do, and not seek instructions” (BGFRS 1950b, p. 11).

Eccles agreed with Sproul, and noted that he also felt “it was time the System, if it expected to survive as an agency with any independence whatsoever, should exercise some independence,” particularly since military expenditures were now greater and because the budget deficit had increased. Eccles supported an increase in the discount rate, as well as increased reserve requirements to immobilize reserves of the banks.

The same day, the Board announced an increase of the discount rate to $1\frac{3}{4}$ percent and the FOMC let the short-term rate increase to $1\frac{3}{8}$. This was the first such change in two years. Furthermore, they noted that they were “prepared to use all the means at our command to restrain further expansion of bank credit” while “maintaining orderly conditions in the Government securities market” (BGFRS 1950b, p. 24).

After the meeting, Chairman McCabe and Sproul met with the treasury secretary and his staff and informed them about the rate increase. Snyder made no comment at the meeting, but he announced right afterward that the Treasury financing for September–October would take place immediately at the old rate of $1\frac{3}{4}$. This was in direct conflict with the recent System announcement, and, as a result, the Federal Reserve was forced to buy most of the new Treasury issue (Meltzer 2003, p. 693).

E. Meetings with Treasury

Later in the fall, the Federal Open Market Committee met four more times without agreeing on further rate hikes. McCabe continued to seek compromise with the Treasury, but the Treasury would not agree to any rate increase whatsoever. The inflation outlook was also more uncertain, and Snyder wanted more time to consult his staff. Sproul and Eccles pressed internally for increased rates, but agreed to wait for a response from the Treasury before going forward.

The lack of an adequate response from the Treasury upset the Federal Reserve, as it became more resentful of the continuing Treasury dominance. System officials were also skeptical about the administration's policy to control wartime inflation. Sproul, in particular, thought the administration's policy relied too much on ineffective quantitative control. He and McCabe met again with Snyder in early January 1951, and Sproul urged the administration to support higher rates so that the Treasury could sell debt without System support.

Snyder reiterated the Treasury's desire for a clear statement from the Fed on the 2½ percent rate, and noted that "the sooner we let the public know that the 2½ percent rate was going to be maintained, the better" (BGFRS 1951a, p. 13). He noted that there was a lot of psychology involved, and argued that investors would stop selling their bonds if the Fed were simply to reassure them that it would maintain the peg (Hetzel and Leach 2001, p. 42). Snyder was still upset by the System's unilateral actions the previous fall:

If you [the Fed] had not jiggled the market the way you did a few months ago, you would not have had to absorb so many bonds from the insurance companies. I think that most of the securities you have been called upon to absorb have been the result of market uncertainty. (Quoted by McCabe in BGFRS 1951a, p. 13)

The meeting ended inconclusively, but again McCabe believed that a compromise was within reach. He was therefore greatly surprised when he read in the newspapers the next day that the treasury secretary had announced that the long-term peg would be maintained for the foreseeable future.

Eccles noted that this was "an extraordinary event in the history of relations between the Treasury and the Federal Reserve," and he quoted *New York Times* journalist Edward H. Collins, who wrote:

"Last Thursday constituted the first occasion in history on which the head of the Exchequer of a great nation had either the effrontery or the ineptitude, or both, to deliver a public address in which he has so far usurped the function of the central bank as to tell the country what kind of monetary policy it was going to be subjected to." (BGFRS 1951a, pp. 484–85)

The announcement came as a special shock to the Federal Reserve System. The Federal Reserve was under the impression that there was an ongoing dialogue with the Treasury on the design of the war financing program. But officially, the Federal Reserve kept a low profile after Snyder's speech. An exception was Eccles, who appeared before Congress shortly afterward at the request of Senator Taft, a leading Republican on the Joint Committee on the Economic Report. The Truman administration tried to prevent his appearance, and they wanted McCabe to appear as the official representative of the Federal Reserve System. But McCabe declined, knowing well that he would be placed in a very difficult position since he could not well defend the Treasury's position. "As Chairman, it

would have been difficult for him to oppose publicly without resigning,” Eccles noted (BGFRS 1951a, p. 486). So he went instead.

Eccles had at this time already drafted his resignation letter to the president (his term expired in 1958), so when he appeared before the committee, he spoke out honestly and clearly. He urged Congress to control expenditures and balance the budget. The financing of war expenses was more complicated in 1951 than it had been during World War II, because capacity was not then fully utilized. If the budget wasn’t balanced now, Eccles warned, “we shall lose the fight against totalitarianism, even though our military and foreign policies are successful in maintaining peace, if we permit inflation to sap the strength of our democratic institutions” (Eccles 1951b, p. 110).

The large holdings of liquid assets among households and companies added to the inflation pressure. Eccles noted that

as long as the Federal Reserve is required to buy Government securities at the will of the market for the purpose of defending a fixed pattern of interest rates established by the Treasury, it must stand ready to create new bank reserves in unlimited amount. This policy makes the entire banking system, through the action of the Federal Reserve System, *an engine of inflation* [emphasis added]. (Eccles 1951b, p. 116)

Eccles added that maintaining the interest peg was equivalent to issuing interest-bearing cash, since the Fed was in effect guaranteeing 2½ percent demand liabilities (Eccles 1951d, p. 2). At those rates, there were far more sellers of government securities than buyers, indicating that the public was not willing to hold at the existing rates. “The only way to restore the balance is to let interest rates go higher to meet public demands” (Eccles 1951b, p. 116).

Members of the committee were concerned about the effects of a rate increase. Congressman Patman asked if it was not “the obligation of the Federal Reserve System to protect the public against excessive interest rates,” and the chairman wondered if “prices of those securities would fall (and interest rates rise) if the Federal Reserve System abandon[ed] its support of Federal securities in the open market” (Eccles 1951b, p. 179).

Eccles responded that the System had “a greater obligation to the American public to protect them against the deterioration of the dollar” (Eccles 1951b, p. 152). He agreed that there would be transitory problems related to a change in rate policy, but noted that “they are not nearly as formidable as the problems that we take on if we accept a frozen interest rate structure” (Eccles 1951b, p. 118). He noted at the end that

all I am saying is this: that either the Federal Reserve should be recognized as having some independent status, or it should be considered simply an agency or a bureau of the Treasury, whose primary function is to carry out the job of Government financing at the will of the Treasury, and at the rates established by the Treasury. (Eccles 1951b, p. 162)

F. Eccles goes public

As tensions rose between the Treasury and the Federal Reserve System, Eccles was soon to play a pivotal role in the unfolding drama. The prelude to this important event was the exceptional meeting of the Federal Open Market Committee with the president on January 31, an unprecedented event that would forever change the history of the System.

Up to the next FOMC meeting on January 31, the Federal Reserve System was faced with heavy selling of the longest Treasury bonds. On January 29, the System let the price decline slightly (by $1/32$), consistent with previous internal discussions that the peg would be maintained, but the premium gradually reduced. This change led to an immediate reaction from the Treasury, which ordered the Fed as the fiscal agent of the United States to purchase bonds at par and $22/32$. As a result the Fed purchased a symbolic amount for the Treasury account at the higher rate, and the rest at par and $21/32$ (BGFRS 1951a, p. 3).

When the FOMC met, McCabe informed them that the president wanted to meet with the entire committee later that same day. As Eccles noted, this was evidently the design of Treasury Secretary Snyder, who had been surprised by the strong negative reactions to his New York speech and tried to regain the initiative (Eccles 1951a, p. 486). But it was still an exceptional request, and the first and only meeting of this kind in the history of the Federal Reserve System (Meltzer 2003, p. 703).

The meeting itself was anticlimactic. The president talked at length about the war effort and the need to maintain confidence in government paper, and that he expected the Federal Reserve System to play its part. But at no point was the issue of maintaining the peg explicitly brought up, and none of the participants from the FOMC mentioned it either.

This may have been intentional, but some felt it was a missed opportunity to make things clear. "The meeting smothered the conflict in ambiguity; everyone seemed to agree but no one changed positions" (Meltzer 2003, p. 705). As the economist Herbert Stein later noted: "The meeting was a masterpiece of deliberate misunderstanding" (Stein 1969, p. 272).

For whatever reason, the president left the meeting with a feeling that Federal Reserve had committed to maintain the rate structure, while the FOMC members were relieved since they had not committed to maintaining the long-term rate.

Even though Treasury Secretary Snyder had not been present at the meeting, the Treasury immediately began to tell its version of what had taken place at the meeting, including the Federal Reserve's continued support for the $2\frac{1}{2}$ percent long-term rate. These stories infuriated Sproul and other Reserve officials (Meltzer 2003, p. 705).

But they were even more surprised when Chairman McCabe received a letter from the president the day after, where he thanked them for their assurances "that the market for government securities would be stabilized and maintained at present levels" (quoted in BGFRS 1951b, p. 3). The letter was a crude attempt (by Snyder) to coerce the Federal Reserve to support the present yield structure, but without any basis in what had been said

at the meeting. McCabe's immediate reaction was to ask the White House to withdraw the letter. This, he noted, could be done without embarrassment for the president, since the letter had not yet been made public.

But later on Friday afternoon, when everybody had left their offices for the weekend, the White House released the president's letter to McCabe. Without consultation and with no possibility for the Federal Reserve to respond, this was the Treasury's "ultimate attempt to impose its will on the Federal Reserve System" (Hyman 1976, p. 347). This was too much for Eccles. If the Treasury view prevailed, the Fed's most important function—open market operations—would be reduced to the level of a Treasury bureau.

It was seven o'clock in the evening and all the other members of the Board, including McCabe, had left town. Eccles was also about to leave when he was called up by the press for a comment on the letter. He reflected on the situation for a while, before deciding that the best way for the System to respond would be for him to release the confidential memorandum from the meeting with the president. It would set the record straight and show that the attempts by Treasury to impose its views had no basis in reality.

As a former chairman of the Board, it was hard for him to breach the confidentiality rules that he so strongly had advocated earlier. However, at this stage of his career in Washington, "he was driven by the conviction that if men lose their minds as well as their souls, there would be nothing left for the times to try," and he knew that he had to assume the responsibility of releasing the memorandum (Hyman 1976, p. 347). Thus, "Eccles made a momentous decision" to go public (Hetzel and Leach 2001, p. 46).

Eccles was able to obtain a copy of the memorandum from the secretary of the Board, without telling him what he intended to do with it. He then made copies for the press and released them the next day, together with a personal statement: "I'm astonished [with the president's letter]. The only answer I can make is to give you a copy of the record of what took place at the White House meeting. . . . Any other comment may be superfluous" (Eccles 1951a, p. 496).

The story was front-page news on Sunday, February 4. As Eccles noted, the general impression was that the president's letter did not give an accurate description of what had happened in the White House. The public clearly understood that the White House was putting pressure on an organization that was meant to be independent of political influence. "As a result of this, public sentiment, and hence congressional sentiment, swung to the support of the Federal Reserve" (Eccles 1951a, p. 496).

G. Next move by the FOMC

By Monday morning, "the fat was in the fire" (Eccles 1951a, p. 496). McCabe called for an immediate extraordinary meeting. This would be a crucial meeting, he noted (BGFERS 1951b, p. 2). At the start of the meeting, Eccles explained his motivation for releasing the memorandum: "I have no regrets. I did what I think was right. If I had to do it over, I would

do exactly what I did” (BGFRS 1951b, p. 16).¹⁰⁶ He went on to explain why he felt it was important for the System to resist the pressure from the Treasury for maintaining the fixed rates. He noted that when the peg had been decided back in 1942, there had been a great deal of slack in the economy. “The situation today is exactly the opposite. Despite a budget surplus, private credit is fueling inflation” (BGFRS 1951b, p. 17).

McCabe then read out a reply to the president’s letter stating the committee’s support for the government securities market but voicing disagreement with his interpretation of the meeting and what had been agreed (or rather not agreed) upon there. All but one of the members agreed to the letter,¹⁰⁷ which was duly dispatched to the White House. He also presented a supplementary letter, sent to Secretary Snyder, inviting the Treasury to discuss what policies might be advisable in the immediate future” and laying out the System’s positions for these discussions:

The Federal Reserve would for some time continue to support the par price of the longest-term restricted bonds.

The Treasury would offer a longer-term bond with more attractive returns to non-bank investors.

The Federal Reserve would limit its purchases of short-term Treasuries.

These terms would become the basis for the subsequent agreement between the Treasury and the Federal Reserve. With this change in policy, member banks would instead be expected to obtain their needed reserves primarily by borrowing from the Federal Reserve Banks (BGFRS 1951b, p. 32).

Despite this attempt by the FOMC to clarify policy, the next day, the president reiterated his understanding (in a press conference) that “the majority of the Federal Reserve Board agreed with him on his interest rate views” (BGFRS 1951b, p. 37). McCabe was obviously not getting his message across. In addition, Secretary Snyder announced that he would be going into hospital for an eye operation, and he therefore asked them to keep rates on hold until he was back. McCabe responded, “Unless someone in Treasury were authorized to work out a prompt and definitive agreement, we will take unilateral action” (Meltzer 2003, p. 708).¹⁰⁸ This then set in motion the consultations that would lead up to the Accord. Snyder appointed assistant undersecretaries Edward Bartelt and William McChesney

¹⁰⁶ Sproul supported Eccles’s publication of the memorandum. No other members voiced support or opposition.

¹⁰⁷ Governor Vardaman, who was a close associate with Snyder, would often disagree with the other FOMC members, and was also at times accused of leaking information to the press.

¹⁰⁸ McCabe was favorable to a postponement, but Sproul was opposed. He wanted to go ahead with discussions with the Treasury right away. There was also strong pressure from Congress to postpone (Meltzer 2003, p. 708n230).

Martin Jr. to negotiate with the Federal Reserve. The System appointed Riefler, Thomas, and Rouse (Meltzer 2003, p. 708).¹⁰⁹

H. Technical discussion

The technical discussions started in earnest on February 20 and then continued with intensive consultations between the two sides in good spirits. When the FOMC next met, in early March, Riefler was able to report on the substantial progress made by the group. He noted in particular that “both sides agreed that monetization of debt must be stopped as far as possible” and that it was essential to proceed carefully, since “the so-called feud between the Treasury and Federal Reserve was a most significant psychological factor in the current situation” (BGFRS 1951d, pp. 10–11). The Treasury had also accepted, after extended discussions, that the Federal Reserve proposal was “essentially a package and not susceptible to very much compromise” (BGFRS 1951d, p. 11).

Martin had been invited to the FOMC meeting to present the Treasury view. He basically endorsed the proposal from the Federal Reserve, but wanted assurances that the change in policy would not lead to sharp increases in interest rates: “We do not want to feel we are starting on a rising pattern of interest rates in what could be a period of war financing” (BGFRS 1951d, p. 17). The Treasury therefore wanted assurances that the Fed would support the current rates in the transition period, as the new nonmarketable bond would be issued. He did not ask for indefinite support, but noted that such support should be forthcoming for the rest of the year (BGFRS 1951d, p. 19).

In the subsequent discussion of the FOMC (only), several members were concerned about the extent and length of System support for the long-term rate (BGFRS 1951d, p. 30). In addition, Sproul emphasized that in no way should the agreement be set within the framework announced by Secretary Snyder in New York. To facilitate further progress, the technical group was then asked to resume work immediately and clarify any remaining issues.¹¹⁰

When the FOMC reconvened the next day, Riefler briefed the committee on the discussion of the previous night. He noted that the sticking point was the possible effect of the program on interest rates and that it was important that both sides understood what a change of policy would mean in terms of market price and rates (BGFRS 1951d, p. 32). It was especially important for the Federal Reserve to note that support for an orderly market did not imply support of the par value. He noted that under the new framework, the Treasury would have to offer issues at attractive rates, not relying on the System for support (BGFRS 1951d, p. 33). There was also agreement that some support for the current peg would be desirable during the new bond issue, but that the Treasury did not see the

¹⁰⁹ Woodlief Thomas was the Board’s chief economist; Winfield Riefler was adviser to the chairman; Robert Rouse was manager of the System Open Market Account.

¹¹⁰ At this stage, Eccles withdrew from the meeting to go to Chicago for a speaking engagement; he was thus not present for the second day of the meeting, but he gave his support to the draft accord before leaving.

need for support for long after the new offering. “We would not find ourselves going into May or June with a peg at that end of the market” (BGFRS 1951d, p. 34).¹¹¹

In the next chapter, we look in detail at the Accord.

Note

References for chapter 2 follow chapter 3.

¹¹¹ As presented to the FOMC on March 1, the resulting agreement reflected Riefler’s original ideas. The Fed would keep the discount rate at $1\frac{3}{4}$ percent through the end of 1951. The Treasury would remove marketable bonds from the market by exchanging them for a nonmarketable bond yielding $2\frac{3}{4}$ percent. To make those bonds liquid and thus more attractive to the market, the Treasury would exchange them upon request for a $1\frac{1}{2}$ percent marketable five-year note. During the exchange, the Fed would support the price of the five-year notes. That support was central because the value of the nonmarketable bonds depended upon the price of the five-year note. However, the Fed made no commitment to support the note’s price beyond purchases of \$200 million (Hetzl and Leach 2001, pp. 50–51).

CHAPTER 3: The Accord and Lessons for Central Bank Independence

Thorvald Grung Moe¹¹²

I. The Accord

When the FOMC's executive committee met on March 3, 1951, McCabe referred to his conversation with the president, who was still concerned about what would happen to the long-term bonds. McCabe had responded that it was difficult to know what might happen, but he was confident that "as the public came to feel that the Government market was no longer regulated, there would be greater confidence in it" (BGFRS 1951e, p. 3). They then discussed how rapidly the market could move, and agreed that the System account would have to be "played by the ear" during the very first days (BGFRS 1951e, p. 4).

Chairman McCabe then referred to the announcement that would be issued jointly by the Treasury and the Federal Reserve, which read as follows:

The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt. (BGFRS 1951e, p. 6)

At the same time, they were informed of the Treasury's conversion announcement, offering for a limited period "a new investment series of long-term nonmarketable Treasury bonds in exchange for outstanding 2½ percent Treasury bonds of June 15 and December 15, 1967–72" (BGFRS 1951e, p. 7).

Riefler added that, as agreed upon with the Treasury, there would be no written understanding as to the extent of the System's support for the longest-term restricted bonds (at $21/32$ or $22/32$ above par), although they would stick to the previous agreement of System support up to \$200 million. Also, there would be "the utmost secrecy about the terms of the understanding" to facilitate the success of the new conversion offering (BGFRS 1951e, p. 8).

Eccles used the occasion to note that he reluctantly supported the agreement with the Treasury, primarily since the conversion issue now "prejudged the market" rather than reflected "the real public market." However, he realized that the compromise program was the best they could get under the circumstances, and that after all, "it was a very important

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step in the direction of a more flexible market and greater freedom in the determination of System open market policies.” McCabe added that “the biggest hope in the agreement was the fact that it marked a new era in Federal Reserve–Treasury relations,” but he also noted that “it was only a beginning of a period of better understanding” and both parties would have to work hard “to see to it that this new spirit of cooperation succeeded” (BGFRS 1951e, p. 12).

The FOMC then approved the agreement. And the next day, Treasury Secretary Snyder approved it as well. The joint statement was then published on Sunday, March 4.¹¹³

A. Aftermath

Even though the Treasury lost the battle of the peg, they did not give up the fight. Secretary Snyder let the president know that he no longer had confidence in Chairman McCabe. Without a working relationship with the Treasury, McCabe could no longer function. He sent a bitter letter of resignation, but later resubmitted a bland version when asked to do so by the White House (Hetzel and Leach 2001, p. 51). Shortly afterward, the president appointed William McChesney Martin Jr., the treasury assistant undersecretary who had so ably conducted the discussion on the Accord, as the new chairman of the Board of Governors.

In the press, this was widely understood to be Treasury’s revenge, and that the Fed had won the battle but lost the war. That is, the Fed had broken free from the Treasury, but then the Treasury had recaptured ground by installing its own man at the helm (Hetzel and Leach 2001, p. 52). But ironically, Martin turned out to be just as eager in defending the Fed’s independence as his predecessors.¹¹⁴ He would go on to serve as chairman for almost 19 years—the longest term of any chairman to this time.¹¹⁵

The market reaction to the Accord was modest. The refunding into the 2¾ percent nonmarketable bonds in April did not greatly change the yield on other long-term debt (Meltzer 2003, p. 713). During the conversion period, the Fed purchased five-year notes as promised to support the price. However, when the Fed had spent the agreed support amount in the first three days, Treasury called and wanted more support. That request was refused, and there was nothing more the Treasury could do about the matter. Henceforth, the Federal Reserve ceased to be a party to the system of pegged prices. “Eccles had won his last battle in Washington” (Hyman 1976, p. 351).

II. Eccles’s Position on Central Bank Independence

¹¹³ At the time, press reports of the Accord did not view it as a major change in either policy or Fed independence (Meltzer 2003, p. 712n234).

¹¹⁴ Leon Keyserling, chairman of the president’s Council of Economic Advisers at the time, said that “Martin promptly double-crossed the President” after becoming chairman (Hetzel and Leach 2001, p. 52).

¹¹⁵ Alan Greenspan served for nearly as long: 18.5 years; Eccles, for almost 16 years.

Eccles became a pivotal player in the Accord drama when he released the classified memoranda from the FOMC meeting with the president, but he did so to protect the integrity and independence of the Federal Reserve. The liberal press admonished Eccles for his perceived switch from a New Dealer to a conservative (Weldin 2000, p. 215), but his actions fit well with his broader view of the dual mandate of central banks to fight inflation and prevent depression. For Eccles, central bank independence became a necessity in 1951: not an absolute virtue, but more like a tactical tool to withstand Treasury pressure for war financing that he saw as inflationary.

Eccles favored consultations and consensus. When the Board discussed monetary policy during World War II, he would tell his colleagues that “it was a mistake for the central bank in any country to regard itself as being completely independent.” It should express its views and thereafter “not try to make its will prevail, but cooperate in carrying out the program agreed upon by the Government” (BGFRS 1942, p. 8).

However, as the war dragged on without signs of tax hikes, Eccles gradually became more concerned with the inflationary consequence. He was also skeptical of the Treasury’s bond programs, and argued that a more restrictive credit policy was needed. But he did not favor a fully independent, omnipotent central bank:

I agree with those who say that Treasury domination of Federal Reserve credit policy is dangerous. I do not go along, however, with the sophomoric contention that the Federal Reserve should be omnipotent or that it should be free to assume an attitude that might be described as “the Treasury be damned.” (Eccles 1951c, p. 1)

The conflict with the Treasury intensified during the postwar period and particularly after the outbreak of the Korean War over continuance of the cheap money policy of the wartime period of heavy deficit financing. Eccles had long favored administrative measures to curb the growth in private credit, but in early 1951 he felt it was time for the Fed to act independently. With Treasury facing a deficit of unknown size it was no longer the responsibility of the Federal Reserve System to underwrite the public debt at fixed prices, but rather “to do everything in its power to curb further expansion of the money supply and further depreciation in the purchasing power of the dollar” (Eccles 1951d, p. 4).

In the midst of the FOMC meeting in early March, when the Federal Reserve was discussing the final touches of the Accord, Eccles went to Chicago to defend their position:

If the Congress does not want the Federal Reserve System to carry out its present statutory responsibilities it should repeal or redefine its powers. Until such time as it does, the System has no choice under the present impact of inflationary pressures but to use its powers in a manner consistent with its responsibilities to the public as well as to the Treasury. To do otherwise, would be to fail in its public duty and would not be in the real interest of the Government. A greater degree of independence on the part of the Federal Reserve System is long overdue. (Eccles 1951d, p. 4)

But, added Eccles, “neither the Federal Reserve nor the Treasury should be omnipotent or dominant; each should consider itself to be an equal partner charged with responsibilities of equal weight” (Eccles 1951d, p. 8).

III. Reluctant Advocate of Flexible Rates

Eccles was a reluctant advocate of flexible interest rates. Immediately after World War II, he opposed increased rates because “it would add to the interest cost of the Government debt and raise bank earnings”; a sharp rise in rates could also cause “a serious drop in the bond market” (Eccles 1946, p. 2). As late as 1949, Eccles was still supporting the low interest rate policy. In a letter to Treasury Secretary Sproul he emphasized “our purpose and policy are based not on a desire for a higher level of interest rates, but entirely to discourage needless monetization of the debt through a wartime mechanism” (Eccles 1949c, p. 11).

When he appeared before Congress in January 1951, Eccles again noted that the Federal Reserve was *not* interested in higher interest rates as such, but only as they could help in curbing the sales (by banks and insurance companies) of government securities, which added to the reserves and deposits of the banking system (Eccles 1951b, pp. 175–76). To curb the sale of government securities, it was necessary for the market to become more self-supporting. “The incidental result of such a development, under current conditions, will be somewhat higher interest rates,” noted Eccles (Eccles 1951d, p. 2).

In a letter to the *American Banker* in 1951 he defended his change of view, and noted that the situation had changed dramatically (Eccles 1951e). Back in 1948 there had been a real risk of deflation, whereas now (in 1951), prices were increasing rapidly. He therefore accused the editor of misrepresenting his views:

The purpose of the article was to make it appear that I am inconsistent in advocating a freer market for long-term Government securities now whereas I earlier favored support for the 2½ long-term yield. But the article completely fails to take into consideration the great difference between the monetary and credit situation then as compared with the situation now. (Eccles 1951e)

Despite his “conversion” to flexible rates, Eccles remained committed to long-term low rates:

In addition to believing that we need a flexible monetary policy with fluctuating interest rates, I believe that we need a generally low level of interest rates as a longer-run matter even though higher rates may be required at times to retard inflationary developments. (Eccles 1950, p. 9)

Lower rates would, according to Eccles, support aggregate spending, keep a downward pressure on savings, stimulate investment, favor the low and middle-income groups in the

distribution of income, and keep down the financial costs of production and hence provide goods more cheaply (Eccles 1950, p. 9). His views on the long-term direction of interest rates were thus unaffected by his tactical support for flexible rates in the acute conflict with the Treasury in the winter of 1950–51.

IV. Importance of Symmetric Policy Response

For Eccles, the fight against inflation in 1951 required a strong and independent Federal Reserve. Since Congress would not give them additional powers to rein in excessive reserve growth, they would have to use the powers Congress had already granted them. The war effort (in Korea) would come to nothing if the destructive powers of inflation were allowed to run their course. As Senator Douglas observed: “In the eyes of those who want to destroy democracy and capitalist institutions, inflation is a cheap way of achieving their collapse” (Meltzer 2003, p. 703n218).

It is interesting to note that Eccles’s concerns for postwar inflation came early. He warned during the war about “a situation in which individual and business consumers, if permitted to buy freely, would in many fields try to purchase greatly in excess of what is available” (Eccles 1944, p. 1). He argued for a shift in policy from the active fiscal stimulus during the Depression years to a more restrictive policy that would enable resources to be shifted into war production and control inflation.

Eccles found that many of his Keynesian allies from the 1930s were slow in perceiving this postwar problem. Many of them were still concerned with the risk of a major slump after the war.¹¹⁶ “Whenever Eccles looked at the update for the ‘liquid assets’ in the nation, the new (upward) figures persuaded him that the immediate post-war years would be marked by a ‘classical’ inflation where ‘too much money chases too few goods’” (Hyman 1976, p. 288). But Eccles was always conscious of the dual mandate of the Federal Reserve: to preserve maximum employment while controlling inflation. This required a symmetric policy response: “It is the duty of the Government to intervene in order to counteract as far as possible the twin evils of inflation and deflation” (Eccles 1935c, p. 1). So Eccles was perfectly happy to support active “pump priming” by the government in the 1930s, while embracing the fight against inflation in the early 1950s. As he had pointed out back in 1935: “Inflation is to be feared only after we have achieved recovery” (Eccles 1935b, p. 15).

Central bank independence was not an absolute virtue for Eccles. Some have described his position as chairman of the Federal Reserve in the 1930s as “virtually an assistant secretary of the Treasury for monetary affairs” (Timberlake 1999, p. 3). But for Eccles, the proper role for the Fed during the Depression was to support the Roosevelt administration’s fiscal program.

Meltzer (2003) describes Eccles as a weak and inconsistent chairman who failed to preserve the integrity of the Federal Reserve under FDR, and only later (after World War

¹¹⁶ Walter S. Salant and Gerard Colm were among some of the other (US) economists who were quick to recognize the new realities of postwar inflation (Hyman 1976, p. 288).

II) recognized the need for more independence. However, this view misses the consistency in Eccles's economic views, especially on the issue of compensatory finance. As much as the Federal Reserve should fight alongside the administration in waging war on unemployment, they should be equally vigilant in the fight against inflation. If the administration prevailed in its "easy money view," then the Fed had to take on the fight alone.

Eccles came around from his guarded support for policy independence in the early war years to a more passionate supporter for central bank independence after the war. Once removed from the chairmanship of the Board, Eccles became even more outspoken against the Truman administration's economic policies. The onset of the Korean War exacerbated the controversy between Eccles and the administration. While he continued to believe that fiscal policies were more potent against inflation than monetary policy, he finally came to support more flexible rates in the face of strong inflationary pressures.

His repeated proposals for budget surpluses and credit constraint irritated the administration and alienated the bankers. But Eccles would persist in promoting his causes despite weak political support. Gradually, the Congress would come along as a supporter of the Fed's position, but the support from top-ranking Republicans Robert Taft and Arthur Vandenberg may have alienated the president so much that Eccles's demotion (in 1948) was inevitable (Weldin 2000, p. 177). Despite this, Eccles continued his fight and finally won. As an active supporter of Sproul and McCabe, he was instrumental in bringing forth the Accord.

Marriner Eccles has been accused of turning with the winds, and being a weak and rather inconsistent chairman and member of the Board of Governors of the Federal Reserve Bank. He can be seen, however, as a pragmatic policymaker who understood that the central bank's policy tools and governance structure are relative to the situation at hand. Therefore, central bank independence and inflation fighting should not be seen as a holy grail to be defended at all cost and all times.

V. Lessons for Central Bank Independence

Gavyn Davies (2012) claims that the battle of the peg "was probably the greatest political battle in the history of central banking": this "epic struggle between a US president who stood on the verge of a nuclear war, and a central bank that was seeking to establish its right to set an independent monetary policy, resulted in an improbable victory for the central bank." Davies thinks the Accord provides important lessons for central banks that are today under increasing pressure to support their sovereigns and cap bond yields. He believes that "this is dangerous territory, which lies right at the heart of a government's relationship with its central bank."

But as we have seen, the history of the Accord can also be read differently, with different lessons to be learned. Seen in a wider historical context and in light of the actions of Eccles, the Accord should be interpreted as part of a broader vision for a compensatory central

bank. According to Eccles, the central bank should be as concerned with depression as inflation. Thus, the lesson today is that central banks should be more concerned with the unemployment problem and supportive of countercyclical fiscal policies—when that is necessary. As Eccles noted before Congress in 1933:

Unless we adopt the necessary corrective measures, we can only expect to sink deeper in distress, with possible revolution, with social disintegration, with the world in ruins, the network of its financial obligations in shreds, with the very basis of law and order shattered. Under such a condition nothing but a primitive society is possible. Why risk such a catastrophe when it can be averted by aggressive measures in the right direction on the part of the Government? (Eccles 1933, p. 705)

The lesson to draw from the Accord is for a less independent, but more effective, central bank that acts in a truly countercyclical fashion in tandem with aggressive fiscal policies. To achieve its objective of business stability, the central bank will also have to gain more control over private credit creation.¹¹⁷ Only in this way can the central bank be a truly compensatory force in the economy.

VI. Lessons from the Accord

Lesson 1: It is remarkable how widely different lessons can be drawn from the history of the Accord.

Many seek to invoke the Accord as support for more independent monetary policy, free from fiscal dominance. Davies (2012) views the Accord as the final “victory over fiscal dominance” and “as the moment when the modern, independent Fed came into existence.” Citibank’s global economics team reviews the Accord history and notes that (fortunately, in their view) there are now “broad understandings of the nature and importance of central bank independence—and the role that monetary policy can play in ensuring favorable economic outcomes” (Sheets and D’Antonio 2012, p. 1). With substantial pressure now building up on central banks to keep rates low (in an environment with elevated government debts), “central banks will need to remain intensively focused on their core mandates and not become distracted by other objectives or political pressures” (Sheets and D’Antonio 2012, p. 14).¹¹⁸

¹¹⁷ For further discussion of this topic, see Moe (2012b).

¹¹⁸ Interestingly, the US Treasury has recently considered issuing floating-rate notes to dampen the negative effects of an exit strategy with increasing rates. The parallel to the 1950s is striking, when the Treasury converted the huge stock of outstanding fixed-term debt at more attractive rates to soften the balance sheet effect of higher rates. But today, there is absolutely no reason for the Treasury to issue floating-rate notes, according to Campbell Harvey, a finance professor at Duke University’s Fuqua School of Business in Durham, North Carolina. “If interest rates go up, it puts the government at risk because they will need to come up with a lot of extra revenue to pay the interest bill” (quoted in Liz Capo McCormick and Meera Louis, “Father of Treasury Floaters Says Now Worst Time for Sales,” Bloomberg, April 30, 2012).

McCulley and Pozsar (2012) provide another interpretation of the Accord's history and the lessons from the 1930s. They support the current ultra-loose policy of the Federal Reserve, and note that "it is actually somewhat similar to the framework of bond-price pegging that occurred during the years before the Federal Reserve–Treasury Accord of 1951" (McCulley and Pozsar 2012, p. 5n3). By keeping rates low for an extended period of time, the central bank supported the government's long-term borrowing program. Unfortunately, fiscal authorities these days are obsessed with balanced budgets. "The problem for central banks currently is therefore not to protect their independence, but to help governments let go of their fears of false orthodoxies that hold them back from borrowing and investing" (McCulley and Pozsar 2012, p. 5).

Still, the Fed's new policy of fixing the expectations of long-term rates at a low level marks the end of a long period of "tussles" between the US Treasury and the Federal Reserve System, where the fiscal authority would have to guess how the monetary authority would react to its fiscal policy decisions. "The decades-long era of Sargent and Wallace's 'Unpleasant Monetarist Arithmetic' [1981] is over" (McCulley and Pozsar 2012, p. 6).

The Accord's history can indeed be interpreted differently, with different lessons to be learned. One group sees the Accord as the end result of an epic struggle to gain central bank independence and price stability. Another interpretation would set the Accord in a broader historical context and view it as a necessary step at that time to fight inflationary pressures, but would refrain from drawing universal lessons about central bank independence from this specific historical experience. Rather, the lesson is that central bank and treasury policies normally need to be coordinated, and that an independent central bank focused on (only) price stability is just one of many possible configurations for such coordination.

Lesson 2: There is a permanent need for coordination between fiscal and monetary policy.

During the Patman Committee hearings, Senator Douglas noted the "inevitable conflict" between the Treasury and the Federal Reserve, and the potential of the two agencies running at cross-purposes (US Congress 1952a, p. 489). During the Accord discussion, Assistant Undersecretary Martin would appeal to the Fed for agreement on the Accord, since "we are in the situation of the Army and the Navy and we have to work together in a war" (BGFRS 1951e, p. 21).

This policy coordination problem has been extensively discussed in the academic literature. Woodford (2001, p. 70) notes: "Our results imply that a central bank charged with maintaining price stability cannot be indifferent as to how fiscal policy is determined." Sargent and Wallace (1981) discussed this coordination problem in their classical article "Some Unpleasant Monetarist Arithmetic." They noted that monetary and fiscal policy should interact in a coherent way in order to deliver a unique equilibrium (Park 2012, p. 4). They also noted that the public's demand for interest-bearing government debt might bind the monetary authority and thus possibly limit its ability to control inflation permanently

(Sargent and Wallace 1981, p. 1). The outcome would very much depend on the way fiscal and monetary policies are coordinated: “Like two samurai facing each other in a duel.”¹¹⁹

Svensson (2012, p. 295) notes that this “duel” can best be resolved if each agency pursues its specific objective, with an eye to what the other is doing: “The equilibrium will be a non-cooperative Nash equilibrium rather than a coordinated equilibrium.” However, Dixit and Lambertini (2003, p. 23) find that if fiscal policy is not constrained, “it may not be worth incurring the political costs of putting in place any mechanism of monetary commitment.”

The coordination problem was supposedly “solved” with the golden rule of balanced fiscal budgets. As Woodford notes, “Commitments to budget balance or to deficit limits have achieved new prominence in macroeconomic policy in the same period that has seen increased emphasis upon central bank independence and actively anti-inflationary monetary policy, both in the US and in the European Union” (Woodford 2001, p. 71). Committing the Treasury to balanced budgets would enable an independent central bank to stabilize the price level. “Establishing and maintaining clear boundaries between monetary and fiscal policies protects the independence of the central bank and its ability to carry out its core mandate—maintaining price stability” (Plosser 2012b, p. 4).

The global financial crisis has led to renewed discussion about the best way to coordinate fiscal and monetary policy. Goodfriend (2001, p. 24) would prefer “the Fed to perform only those functions that *must* be carried out by an independent central bank,” and Lacker (2009, p. 7) adds that “the Fed’s primary focus should be the management of its monetary liabilities” (and nothing else). They have both been concerned with the recent quasi-fiscal liquidity operations of the Federal Reserve System during the crisis, and think that such credit policies could compromise central banks’ independence and even their inflation targeting credibility. Peter Praet (2012, p. 5) discusses this policy challenge in the context of the current financial crisis in the euro area:

When calls are made for a central bank to play the role of “lender of last resort” in government bond markets, such calls effectively amount to the central bank being asked to directly fund illiquid sovereigns, either via direct interventions on the primary market or by extending direct credit lines. Such activities are not legally within the reach of the ECB, since the Treaty clearly imposes the prohibition of monetary financing (Article 123 TFEU). There must not be any circumvention to this prohibition. Again, this Treaty provision was not chosen arbitrarily. It is based on the experiences in many countries over several decades, which taught us that a central bank that bows to the needs of public finances cannot ultimately be successful towards delivering upon its medium-term oriented price-stability objective. In particular, moral hazard could weaken incentives for governments to pursue fiscal consolidation to safeguard or restore fiscal sustainability. This will

¹¹⁹ “A Japanese Duel,” *Financial Times*, June 17, 2012, in a discussion of the policy standoff between the Bank of Japan and the Diet.

ultimately endanger price stability and macroeconomic stability more generally.

The situation in the euro area is somewhat idiosyncratic, but there is a common perception among central bankers that they have to be “especially vigilant to shield monetary policy from attempts to engross it into inappropriate financial stability tasks,” since such attempts may turn out to be “disguised aspirations to drag the well-established paradigms of monetary dominance towards the realm of fiscal dominance” (Praet 2012, p. 5).

But as we discussed earlier, this view of central banking elevates the Accord experience to a universal truth valid in all cyclical stages. Such an interpretation is in our view incorrect. And as Kocherlakota (2011, p. 3) recently observed: “It may turn out to be optimal for central banks to guarantee fiscal authority debts in some situations. If so, we again have to think of price level determination as something that is done jointly by the fiscal authority and the central bank—just as Sargent and Wallace taught us 30 years ago.”¹²⁰

In the following two chapters we will take a different view in addressing in more detail the necessity of coordination between fiscal and monetary policy operations.

Lesson 3: Central banks should not be omnipotent: The central bank is “independent within the government.”

According to President Sproul of the Federal Reserve Bank of New York: “The independence of the Federal Reserve System does not mean independence from the Government but independence within the Government” (US Congress 1952a, p. 983). The subcommittee endorsed this view, since the Federal Reserve had substantial independence but was nevertheless accountable to Congress and also affected by the president’s appointment of its Board members. Despite these relations, they noted that the Federal Reserve was formally independent and could make its own policy decisions without interference from the administration.

But, the subcommittee added, “This formal independence of the Board of Governors from the president is inevitably limited by the hard fact that fiscal and monetary policy must be coordinated with each other and with the other policies and objectives of the Government” (US Congress 1952b, p. 52). According to the committee, there should be more discussion of economic policies between the executive agencies, since “what is needed is not the best monetary policy or the best fiscal policy, but the best overall economic policy (US Congress 1952b, p. 52). The question was how this policy coordination should best take place.

Senator Douglas (who was a member of the Patman Committee) characterized the potential conflicts between the Treasury (wanting to issue debt at low rates) and the Federal Reserve (wanting to curb inflation with higher rates) as: “Here you are, twins, Siamese twins, but with no central coordinating nervous structure to dictate a uniform

¹²⁰ Narayana Kocherlakota is president of the Federal Reserve Bank of Minneapolis.

policy” (US Congress 1949, p. 489). His solution was a clearer mandate for the Federal Reserve—“to be a counterweight to cyclical economic fluctuations” (US Congress 1952b, p. 76). Clearer demarcations of each agency’s prime responsibility would be better than the committee’s vague “common responsibility” theory of the Treasury – Federal Reserve System relations. And he noted in his written dissent to the report that the proper principle was “Good fences makes good neighbors”:

In short, I make the point of differentiation of responsibility, and make it insistently, because it seems clear to me that we will have a better end result, and that the Treasury and the System will be better neighbors in the long run, the less they invite themselves in to play in each others' backyards. (US Congress 1952b, p. 76)

Despite his (and Eccles’s) efforts, the Federal Reserve’s objective remained unchanged, even though the committee broadly endorsed the Fed’s newly gained independence. They noted, however, that

the independence of the Federal Reserve System is a relative, not an absolute, concept. It is good insofar as it contributes to the formulation of sound policy, and bad insofar as it detracts from it. Measured by this standard, the Subcommittee is inclined to believe that a degree of independence of the Board of Governors about equal to that now enjoyed is desirable. (US Congress 1952b, p. 52)

But, they added, “The Board of Governors, like all other parts of Government, must play as part of a team, not as an outside umpire, and must ultimately abide by the decisions that are made by Congress” (US Congress 1952b, p. 53). In this sense, they expected the newly independent Federal Reserve to be a team player.

Lesson 4: Central banks should fight inflation and prevent deflation.

The Accord was a solution to a specific coordination problem. At the time, the US economy was close to capacity and there were strong inflationary pressures. Today, many countries are facing mass unemployment and low inflation. This is certainly a situation in which Eccles would have advocated fiscal expansion supported by central bank monetization. But central banks are currently strongly opposed to such action, as they continue to support their narrow mandates of inflation targeting (IT).

There is, however, a growing debate about the inflation-targeting paradigm. Jeffrey Frankel noted recently that the current policy regime failed to respond adequately to asset market bubbles and also give inappropriate policy responses to supply shocks and terms of trade

shocks.¹²¹ Other economists have also raised questions about the current IT paradigm. Olivier Blanchard (chief economist at the IMF) raised the question two years ago: “To be concrete, are the net costs of inflation much higher at, say, 4 percent than at 2 percent, the current target range? Is it more difficult to anchor expectations at 4 percent than at 2 percent?” (Blanchard, Dell’Ariccia, and Mauro 2010, p. 11). Nobel Prize-winner Robert Engle also observed that “a little bit of inflation would do a whole lot of good for the US economy [and] would certainly do a lot of good for the housing market. If we had just a little bit of inflation and house prices went up, all the sudden they’d be above the mortgages.”¹²² But such suggestions have so far been met with massive silence or have been described as irresponsible and “reckless.”¹²³

Eccles favored a broader central bank objective that would “promote business stability and moderate fluctuations in production, employment, and prices” (US Congress 1935, p. 290). Senator Douglas wanted the Fed to be “a counterweight to cyclical economic fluctuations” (US Congress 1952b, p. 76). As Frankel (2012) notes, there is still strong resistance among central bankers to give up the hard fought anchor of 2 percent inflation. But as pressure builds for a change in policy paradigm,

the attraction of nominal GDP targeting is that one could set a target for nominal GDP that constituted 4 or 5 percent increase over the coming year—which for a country teetering on the fence between recovery and recession is in effect a 4 percent inflation target—and yet one would not [formally] be giving up the hard-won emphasis on 2 percent inflation as the long-run anchor.

It is possible that nominal GDP targeting will replace the inflation target as a monetary regime for the future.

Lesson 5: Control of private finance is a prerequisite for financial stability.

Excessive private credit creation was the key policy challenge facing the Federal Reserve after World War II. The Truman administration ran budget surpluses for several years, but strong bank lending neutralized their effects. “The banks, in other words, created an amount of money just about as fast as the Federal Government, through its fiscal policy, contracted the money supply” (Eccles 1948, p. 8). Eccles and his contemporaries were very

¹²¹ Jeffrey Frankel, “The Death of Inflation Targeting,” Vox.eu, June 19, 2012. The governor of the Bank of Canada, Mark Carney, has also voiced support for a reconsideration of central bank objectives; see his speech on central bank guidance (Carney 2012).

¹²² Quoted in Sandrine Rastello, “Engle Joins Krugman Suggesting Higher Inflation for U.S.,” Bloomberg, May 1, 2012.

¹²³ Paul Krugman’s suggestion that the Federal Reserve tolerate inflation of 3 percent to 4 percent in order to boost the economy was rejected by Fed Chairman Ben S. Bernanke, who said such a policy would be “reckless.”

concerned about the banks' ability to "create money." This quote from a Federal Reserve paper to Senator Douglas in 1951 illustrates their thinking:

Most of us . . . are likely to suppose that the banker lends to other people the money that we deposit in his bank. That is not the case if we look at the banking system as a whole. The outstanding fact, which is so little comprehended, even among bankers who are supposed to know about such things, is that the banking system creates money. (BGFRS 1951c, p. 3)

Over time, the concern with excessive money growth has shifted more toward control over the fiscal deficit. For example, Woodford (2001, pp. 70–71) notes that "a central bank charged with maintaining price stability cannot be indifferent as to how fiscal policy is determined. A desirable solution will be to constrain fiscal expectations so that stable prices will not require explosive debt dynamics."

But the recent crisis showed that a rapidly growing banking system could push the financial system over the brink through uncontrolled private credit growth and expansion of "near moneys." This was a policy problem that was very much discussed by Eccles and his colleagues, as they tried to figure out how the government could regain control of the (growth of) society's money supply.¹²⁴ This problem of runaway credit was also notable in many countries before the recent crisis; it was private credit that was the big problem, not big fiscal deficits. Still, for many economists this feature of the crisis has been hard to comprehend. As Gorton and Metrick (2012, p. 1) note: "Many professional economists now find themselves answering questions from their students, friends, and relatives on topics that did not seem at all central until a few years ago, and we are collectively scrambling to catch up."

But the key dynamics of the recent crisis—massive leverage and credit expansion, fed by a shadow banking system that contributed to a housing bubble and then a crash—had long been a central part of the theoretical tradition of both Keynes and Minsky.¹²⁵ Now these insights have to be integrated into mainstream economic thinking as well as a new paradigm for central banking that focuses as much on controlling private credit as it is concerned with public deficits.

Lesson 6: Central banks should support compensatory fiscal policy in a depression.

Eccles argued forcefully that only the government had the money-creating powers that could end a depression. He argued correctly that a nation that issues debt denominated in its own currency could never go bankrupt, since "it owes the debt to itself." The central

¹²⁴ See Moe (2012a) for a discussion of the policy challenges of strong credit growth and the expansion of shadow banking.

¹²⁵ See L. Randall Wray and Éric Tymoigne, *The Rise and Fall of Money Manager Capitalism* (New York: Routledge, 2013).

bank should therefore support such fiscal efforts in downturns, since there will be no immediate risk of inflation and never any risk of insolvency.

Eccles's heterodox policy position is at odds with current central banking doctrine, as articulated by Fed President Plosser:

When the Fed engages in targeted credit programmes that seek to alter the allocation of credit across markets, it is engaging in fiscal policy. While it is popular to view such blurring of the boundaries as "cooperation" or "coordination" between the monetary and fiscal authorities during a crisis, ignoring the boundaries puts an economy's longer-term performance at risk.¹²⁶

This belief in the negative consequences of excessive money growth is the reason that country after country has moved to establish and maintain independent central banks, according to Plosser. Without independent central banks, the temptation to use the printing press in the absence of fiscal discipline would just be too great (Plosser 2012a, p. 3).

According to the prevailing paradigm, "the bulk of the responsibility for resolving this crisis lies with national governments,"¹²⁷ and "pressing the ECB into the role of ultimate buyer of public debt of individual member states would create the biggest conceivable moral hazard ever; . . . the prohibition of monetary financing is an indispensable element for a stable currency" (Issing 2011). Davies (2012) adds that "the idea that the central bank should place a cap on the level of bond yields [in the eurozone] . . . is dangerous territory—which lies right at the heart of a government's relationship with its central bank."¹²⁸ And Peter Praet of the ECB adds: "It is essential that the clear demarcation lines provided in the Treaty are not violated or shifted. This would constitute a lasting damage and institutional regress to our well-serving monetary policy framework, which would be intricate or even impossible to reverse" (Praet 2012, p. 5).

But what will happen if the current austerity policy does not work and the crisis deepens? Martin Wolf (2012) of the *Financial Times* notes,

If the eurozone were to enter a meltdown, UK policy would have to become far more aggressive. The government and the BoE would have to consider what are now regarded as widely unconventional schemes: large-scale direct funding of much enlarged fiscal deficits by the BoE; massive intervention by the BoE in foreign exchange markets; or large-scale government guarantees of bank funding and lending.

¹²⁶ Charles Plosser, "When a Monetary Solution Is a Road to Perdition," *Financial Times*, May 17, 2012.

¹²⁷ Jorg Asmussen, quoted in Peter Spiegel and Gerrit Wiesmann, "Draghi Calls On EU Leaders for 'Brave Leap,'" *Financial Times*, May 24, 2012,

¹²⁸ Note the similarity with war financing in the United States and the establishment of the peg of 1942.

The current policy mix of ultraloose monetary policy and tight fiscal policy is not working.¹²⁹ What is missing (in the United States) today is “a fiscal authority with a willingness to spend and respond to the Federal Reserve’s unprecedented stance to willingly encourage and accommodate fiscal expansion to facilitate the private sector’s deleveraging without depression” (McCulley and Pozsar 2012, p. 45). The same could be said with even more force in the case of the European Monetary Union, which has no central fiscal authority.

What we need now, as in the 1930s, is forceful stimulus, both through fiscal and monetary means. The Federal Reserve is waiting for the government to do its part in the United States, while the ECB has been doing its part only reluctantly so far, partly with reference to the treaty’s provisions on central bank independence. Unfortunately, therefore, fiscal stimulus seems to be far away in Europe due to the current strong embrace of the doctrine of “balanced budgets.” The US has not done much better—even though it is not constrained in the same way.

Lesson 7: We need a change in the current central banking paradigm.

The Patman Committee concluded that central banks should not be independent of the government (US Congress 1952b, p. 51). The Federal Reserve is accountable to Congress, which delegated its right to issue money, and the Fed also needs to heed the views of the president and his administration, even if at a safe distance. A review of the Douglas and Patman reports today reveals how closely intertwined monetary policy and politics was and is, and also how similar the policy issues are today.

The current crisis has led to renewed requests for more political control over the Federal Reserve (and some other central banks as well), and there have been several attempts to rein in their independence.¹³⁰ Sproul discussed these same issues in 1948, when he observed that

I don’t suppose that anyone would still argue that the central banking system should be independent of the Government of the country. The control which such a system exercises over the volume and value of money is a right of Government, and is exercised on behalf of Government, with powers delegated by the Government. But there is a distinction between independence from Government and independence from political influence in a narrower sense. The powers of the central banking system should not be

¹²⁹ See IMF (2012) for an assessment of the UK economy and some arguments for delaying the planned fiscal tightening.

¹³⁰ After the recent crisis, Congress was successful in having the Government Accounting Office conduct an independent review of the books of the Federal Reserve, and the Fed was forced to reveal detailed customer information related to its crisis management operations. See our previous Ford project annual reports: Wray 2012, 2013.

the pawn of any group or faction or party, or even any particular administration, subject to political pressures and its own passing fiscal necessities. (Sproul 1948; quoted in Meltzer 2003)

This interpretation of central bank independence was supported by the Patman Committee in 1952, but would not be consistent with the “omnipotent” role of the ECB. As we have noted above, the independence of central banks can only be viable if it delivers superior policy outcomes over time. Today, the current paradigm of an independent central bank targeting a narrow price goal is under renewed pressure because the model is increasingly seen as an obstacle to optimal policy execution. And, as our discussion of the Accord has shown, the current view of central bank independence is based on a misreading of the historical evidence.

Ugolini (2011, pp. 23–24) argues that “organizational structures for the provision of central banking functions vary over time in response to changes in the surrounding political and financial environment, and the present form is certainly not the only viable institutional solution.” Therefore, “the current organizational structures should not be seen as set in stone.” He adds:

The same is the case for the implementation of government deficit monetization. In the long history of sovereign borrowing, periods of predominantly direct recourse to financial markets have alternated with periods of debt monetization—the latter being the norm in times of market dysfunctionality. As a result, monetization should not necessarily be seen as evil, but rather as an option to be subjected to a benefit-cost assessment—in the light, of course, of the constraints imposed by the institutional arrangements in force. (Ugolini 2011, p. 24)

On the whole, he concludes, “historical evidence suggests that the efficiency of any solution (concerning both organizational forms and monetary policies) crucially depends on the sustainability of the institutional arrangement backing them.” Eccles would have agreed. The history of the Accord should teach central bankers that independence at times is crucial for fighting inflation, but also encourage them to be more supportive of government efforts to fight deflation and mass unemployment.

It is time for a more balanced central banking paradigm supporting compensatory policies—in the spirit of Eccles.

In the next two chapters we look in detail at the links between the central bank and the treasury, arguing that there are additional reasons to question the degree of independence that is actually possible. Much of the discussion that has taken place among academic economists has focused on very narrow views of what central bank independence means. It has left to the side important operational considerations that force coordination. After all, the central bank is normally the “government’s bank,” and the government’s spending cannot be independent from its bank any more than the spending of a firm can be independent from its bank.

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CHAPTER 4. Coordination between the Treasury and the Central Bank in Times of Crisis¹³¹

Éric Tymoigne

I. Introduction

One of the main contributions of modern money theory (MMT) has been to explain why monetarily sovereign governments have a very flexible policy space that is unencumbered by financial constraints. Not only can they issue their own currency to pay public debt denominated in their own currency, but also any self-imposed constraint on budgetary operations can be bypassed easily. Through a detailed analysis of the institutions and practices surrounding the fiscal and monetary operations of the treasury and central bank of the United States, the eurozone, and Australia, MMT has provided institutional and theoretical insights into the inner workings of economies with monetarily sovereign and nonsovereign governments.

In terms of theory, MMT argues that taxes and bond offerings are not best conceptualized as funding sources for the treasury, but rather as reserve draining devices to maintain price and interest-rate stability. As such, they are necessary even if a government issues its currency to spend. This theoretical conclusion holds even if the treasury may be required to tax and issue bonds to fund itself. Another theoretical conclusion is that merging the central bank and the treasury in a government sector can be done without loss of generality for a monetarily sovereign government. Separating the two adds complexity without adding insights (Mosler 1999; Bell 2000; Bell and Nell 2003; Bell and Wray 2003; Wray 1998, 2003a, 2003b, 2003c, 2012; Fullwiler 2006, 2009, 2011, 2013.; Mitchell and Mosler 2002; Mitchell and Muysken 2008).

This chapter shows that the previous theoretical conclusions of MMT can be illustrated by providing further evidence of the interconnectedness of the treasury and the central bank in the United States. The first section shows that the early monetary history of the United States provides a direct validation of the MMT theoretical insights. It was a period free of self-imposed constraints, and the rest of the chapter shows how some of the constraints have been bypassed in order to promote financial stability. The second section analyzes the role of the US Treasury in monetary policy. The third section focuses on the funding cost and mechanisms of the Treasury.

¹³¹ This chapter is based on “Modern Money Theory and Interrelations between the Treasury and the Central Bank: The Case of the United States” by Éric Tymoigne, Working Paper No. 788, Levy Economics Institute of Bard College, March 2014.

II. Fiscal Operations during the Massachusetts Bay Colonies: A Textbook Application of MMT

In the early years of the US monetary system, the fiscal and monetary operations of the government were much simpler. There was no central bank, no primary market, and no debt limit. When a colonial government decided to spend, it issued its own securities to the public with a promise to take them back when tax payments were due. The bills of credit

were by their terms receivable at the treasury in payment of government dues. They were originally put forth in anticipation of taxes, and provision in the tax levy was made . . . for a tax which should furnish the means for the prompt retirement of the bills emitted. . . . A part only of these notes was destroyed on their return to the treasury. Those remaining in the treasurer's hands were made use of at a later date by the province as a currency. (Davis 1901, pp. 10, 15, 20)

Unconvertible bills were injected when the Treasury spent and drained when taxes came due. While residents of the colonies were first skeptical about the value of the bills for economic and political reasons, they rapidly came to be used as currency and circulated at par:

When the government first offered these bills to creditors in place of coin, they were received with distrust. . . . Their circulating value was at first impaired from twenty to thirty per cent. . . . Many people being afraid that the government would in half a year be so overturned as to convert their bills of credit altogether into waste paper. . . . When, however, the complete recognition of the bills was effected by the new government and it was realized that no effort was being made to circulate more of them than was required to meet the immediate necessities of the situation, and further, that no attempt was made to postpone the period when they should be called in, they were accepted with confidence by the entire community . . . [and] they continued to circulate at par. (Davis 1901, 10, 15, 18, 20).

It is straightforward to conclude that the funding capacity of the government was unlimited and that taxes were not a funding mechanism. Tax liabilities were a means to create a demand for the currency, taxes drained bills out of the economy, and tax collections validated the expectations of the population about taxes, thereby making the population willing to accept the bills in payment for goods and services.

The governments of colonies came to appreciate the importance of setting clear expectations regarding future tax collections and in implementing collections. However, they also noted that taxes tended to drain too many bills out of the economic system compared to what was desired by private economic units. This created a dilemma:

The retirement of a large proportion of the circulating medium through annual taxation regularly produced a stringency from which the legislature

sought relief through postponement of the retirements. If the bills were not called in according to the terms of the acts of issue, public faith in them would lessen, if called in there would be a disturbance of the currency. On these points there was a permanent disagreement between the governor and the representatives. (Davis 1901, p. 21).

Some knowledge of national accounting helps to solve this dilemma because, as long as the private sector desires a net accumulation of bills, there is no need to retire all of them through taxation in order to maintain their value—a government deficit is an equilibrium position (Godley and Lavoie 2007). Private economic agents desired to hold bills for purposes other than the payment of tax liabilities; namely, daily expenses, private debt settlements, and precautionary savings. All this is in line with MMT’s theoretical conclusion that the equilibrium fiscal position is ultimately determined by the desired net financial accumulation of the nongovernment sector, and that government can run a deficit because its currency is desired for purposes other than taxation (Wray 2012).

Today, the US Treasury’s fiscal operations and the Federal Reserve’s monetary operations are constrained in multiple ways. One of the points of MMT is to show that these constraints are self-imposed and do not change the core purpose of taxes and bond offerings; moreover, the Treasury and Federal Reserve can, and do, easily bypass these constraints. MMT concludes that the case of the Massachusetts colonies is complex enough to shed light on the fiscal and monetary operations of contemporary economies with a monetarily sovereign government.

III. Monetary Policy: The Role of the Treasury

A. Fiscal balance and interest rate stability

A fiscal deficit lowers the federal funds rate (FFR), which tends to lower other interest rates. While this was quite controversial when first noted by MMT proponents, it is now more widely accepted (Lavoie 2013). This ought to be the case, because this conclusion is not theoretical but rather factual. It comes from the balance sheet accounting of the Federal Reserve; see Figure 1.

Figure 1. Simplified Balance Sheet of the Federal Reserve

Assets	Liabilities and Net Worth
A ₁ : US Treasuries A ₂ : Other assets	L ₁ : Liabilities held by banks and the rest of the domestic private sector L ₂ : Liabilities held by the Treasury L ₃ : Liabilities held by others and net worth

L₁ is approximately the monetary base (Treasury currency held by the domestic private sector must be added), and L₂ is the outstanding amount of Federal Reserve notes and Federal Reserve accounts held by the Treasury. Given that a balance sheet must balance, we know that:

$$L_1 \equiv A_1 + A_2 - L_2 - L_3$$

To simplify, let us assume that all economic transactions involve electronic transfers of funds (no use of Federal Reserve or Treasury currency). As the Treasury spends in the domestic economy (L₂ goes down), the amount of reserves held by banks rises (L₁ goes up) as the Treasury credits the bank accounts of nonbank economic units. As the Treasury taxes (L₂ goes up), the amount of reserves held by banks declines (L₁ goes down). If the Treasury spends more than it taxes (i.e., runs a deficit), there is a net increase in L₁ due to an increase in the amount of funds at the Federal Reserve accounts of banks. Surpluses lead to exactly the opposite effect: they drain reserves out of the banking system and so reduce the monetary base.

Given that the demand for reserves by banks is highly inelastic, in normal times any excess reserves will tend to push down the FFR toward zero, and any shortage of reserves will drive up the FFR.¹³² Thus, the Federal Reserve will need to offset the Treasury's fiscal operations unless it targets a FFR of 0 percent (with a deficit) or gives up FFR targeting. Both the Treasury and the central bank are involved in these reserve management operations to maintain interest-rate stability.

If one focuses on a deficit, the central bank drains excess reserves by moving A₁ in the opposite direction of L₂; the traditional open market operations (OMOs). OMOs involve selling Treasuries to banks so that A₁ declines and excess reserves are drained (L₁ declines). However, the central bank has a limited amount of Treasuries that it can use for OMOs, so the Treasury must supply an adequate amount of Treasuries for FFR targeting to be effective.

¹³² This is a simplification. In a stable economic condition, banks may want to hold a small amount of excess reserves to avoid overdraft in interbank settlements and to meet customer withdrawals (Marquis 2002).

More broadly, a growing economy requires a growing monetary base and therefore a growing amount of assets held by the Federal Reserve (given the FFR target), which usually means that the amount of Treasuries held by the Federal Reserve must rise. If there is a fiscal surplus, the outstanding amount of Treasuries shrinks, which is a problem for a central bank that performs OMOs with that instrument. In addition, if the Federal Reserve acquires a too-high proportion of Treasuries, it will disturb the liquidity of the Treasury markets and so the foundation of financial markets. The Federal Reserve explicitly wants to prevent that through a cap in terms of the proportion of Treasuries that it can hold (35 percent for T-bills, 15 percent for T-bonds) (Marshall 2002).

The growing fiscal surpluses of the late 1990s created a problem for the Federal Reserve. Members of the Federal Open Market Committee started to discuss what alternative securities the Federal Reserve could buy if surpluses continued as predicted by the Government Accountability Office. Leaving the United States for a moment, the Australian Treasury was in the same situation in the early 2000s, and came to the conclusion that treasuries were crucial for a well-functioning financial industry. As a consequence, the Australian Treasury decided to continue issuing treasuries even though it was running surpluses (Commonwealth of Australia 2003). An alternative answer to this problem is for the central bank to issue its own interest-earning liabilities.

Beyond the provision of an adequate supply of Treasuries, the US Treasury is also involved in FFR targeting through the use of the Treasury tax and loan accounts (TT&Ls). TT&Ls are accounts of the Treasury at private banks. These accounts were first set up in 1917 to receive proceeds of liberty bond offerings, and in 1948 they also began to receive tax collections. The Treasury does not spend out of these accounts. When it needs to spend, the Treasury transfers funds from its TT&Ls to its Federal Reserve general account. The Treasury general account (TGA) is the main part of L_2 , and transfers of funds from the TT&Ls into the TGA drain reserves (L_2 goes up, L_1 goes down) (US Treasury 1955; US Senate 1958).

TT&Ls were created explicitly for the purpose of smoothing the impact of Treasury fiscal operations on reserves. For example, when the Treasury receives tax payments, it does not immediately transfer them into its TGA but rather keeps the funds in its TT&Ls. This helps the Federal Reserve tremendously to estimate reserve supply conditions in the federal funds market, and so to know how many OMOs are needed. Bell (2000), US Treasury (1955), MacLaury (1977), and Meulendyke (1998) show that the daily coordination between the Treasury and the Federal Reserve is extensive.

B. Treasury's monetary policy during the 2007–08 crisis

In usual circumstances, OMOs and TT&L transfers are enough to help stabilize the FFR at its target, but these tools became insufficient during the recent financial crisis. In December 2007, the Federal Reserve started to provide reserves to banks with liquidity problems through the discount window and emergency lending facilities (such as the Term Auction Facility, followed by many others). These banks then paid their creditors, which led to

excess reserves in the federal funds market. At that time, the FFR target was 4.25 percent and the Federal Reserve removed any unwanted reserves induced by the emergency loans. The goal was to maintain an amount of nonborrowed reserves consistent with the FFR target while helping financial institutions in difficulty.

In six months, the Federal Reserve sold about 40 percent of its Treasuries, and it had about \$480 billion left in June 2008. The amount of Treasuries available for OMOs was actually smaller because, in March 2008, the Federal Reserve started to lend some Treasuries for a month through the Term Securities Lending Facility (TSLF). In June 2008, the unencumbered amount of Treasuries available for OMOs was around \$360 billion. By July 2008, a period of relative calm set in and emergency borrowing at the Federal Reserve no longer grew. The Federal Reserve had been successful at maintaining the FFR around its target that was down to 2 percent in July. It was, however, evident that the Federal Reserve would rapidly run out of Treasuries if more emergency borrowing occurred with a FFR target significantly above zero.

On September 15, Lehman Brothers failed, and this triggered a panic. The Federal Reserve responded by providing reserves through its emergency credit lines. By October 2008, it had injected over \$1 trillion of reserves through these means, which was inconsistent with an FFR target of 2 percent. However, draining \$1 trillion of reserves would have required selling many more assets than the amount of unencumbered Treasuries that amounted to about \$250 billion in October and that were potentially needed for the TSLF. Instead, the Federal Reserve used two strategies. The first strategy was to progressively lower the FFR target to 1.5 percent in early October, 1 percent at the end of October, and 0 to 0.25 percent in mid-December 2008. However, before it reached that 0 percent FFR target, the Federal Reserve had to drain excess reserves, and this is where a second strategy was employed that involved the Treasury in two ways.

First, as shown in Figure 2, the Treasury transferred funds into its TGA, which went from \$5 billion in 2007 to \$35 billion in 2008, and eventually to \$110 billion in 2009. Most of the funds came from its TT&Ls, which went from \$70 billion in 2007 to \$39 billion in 2008, and to \$2 billion in 2009. However, the drainage of \$30 billion of reserves in 2008 and another \$80 billion in 2009 was not big enough to offset the \$1 trillion injection of reserves; see Figure 3. Given that the Federal Reserve was unwilling to sell its remaining unencumbered Treasuries, it asked the Treasury to issue T-bills for that purpose:

Today [September 17, 2008], the Treasury Department announced the initiation of a temporary Supplementary Financing Program. The program will consist of a series of Treasury bill auctions, separate from Treasury's current borrowing program, with the proceeds from these auctions to be maintained in an account at the Federal Reserve Bank of New York. Funds in this account serve to drain reserves from the banking system, and will therefore offset the reserve impact of recent Federal Reserve lending and liquidity initiatives. (FRBNY 2008)

The Treasury (2008) issued the following statement:

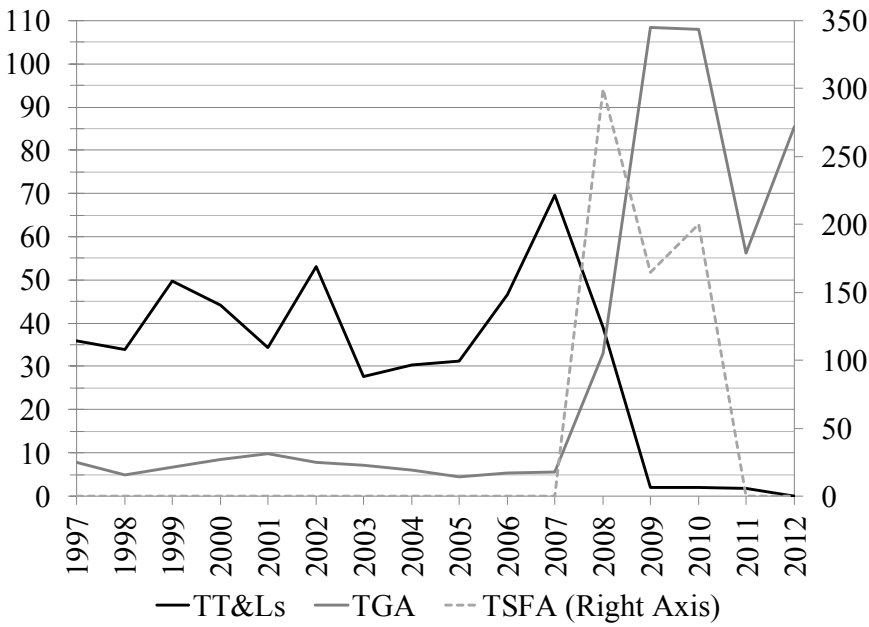
The Treasury Department announced today the initiation of a temporary Supplementary Financing Program at the request of the Federal Reserve.

The outstanding amount of supplementary financial program (SFP) bills rose rapidly to \$560 billion at the end of October 2008 and stayed there for a month. All funds obtained were put into a Treasury Special Funding Account (TSFA) at the Federal Reserve. After November, the amount of SFP bills declined quite dramatically, which led to instability in short-term markets. The Federal Reserve asked for more assistance, but the Treasury was reluctant to help because of a growing debt-ceiling debate in Washington, D.C. (Ramanathan 2010). Ultimately, the Treasury agreed to roll over \$200 billion in SFP bills, even though at the end of 2009 and beginning of 2010 their outstanding amount dropped to almost zero. After February 2011, the outstanding amount of SFP bills progressively declined, and by August 2011 all SFP bills had matured.

Overall, the Treasury helped drain up to \$610 billion of reserves in October and November 2008 via the TT&L transfers and the SFP bills. While Treasury operations were not enough to bring the FFR close to its target (the FFR was consistently 600 basis points or more below target; see Figure 4), they prevented a complete fall of the FFR to zero. In theory, the SFP bill rate provided a floor to the FFR since T-bills trade at a rate slightly below the FFR, but the FFR fell below the rate on SFP bills because not enough of them were supplied to financial institutions with excess reserves. With the introduction of interest payments on reserve accounts on October 9, 2008, SFP bills became theoretically redundant; however, the Treasury kept issuing them for at least two reasons (Santoro 2012, p. 8). First, SFP bills removed a substantial amount of reserves and so helped to preserve interest stability. While the interest rate on reserves is supposed to provide a floor for the FFR, this only applies if all entities with reserves can get an interest-paying account at the Federal Reserve, which is not the case for government-sponsored enterprises and some international institutions (Kahn 2010). Second, offerings of SFP bills satisfied a demand by the financial industry for default-free credit instruments.

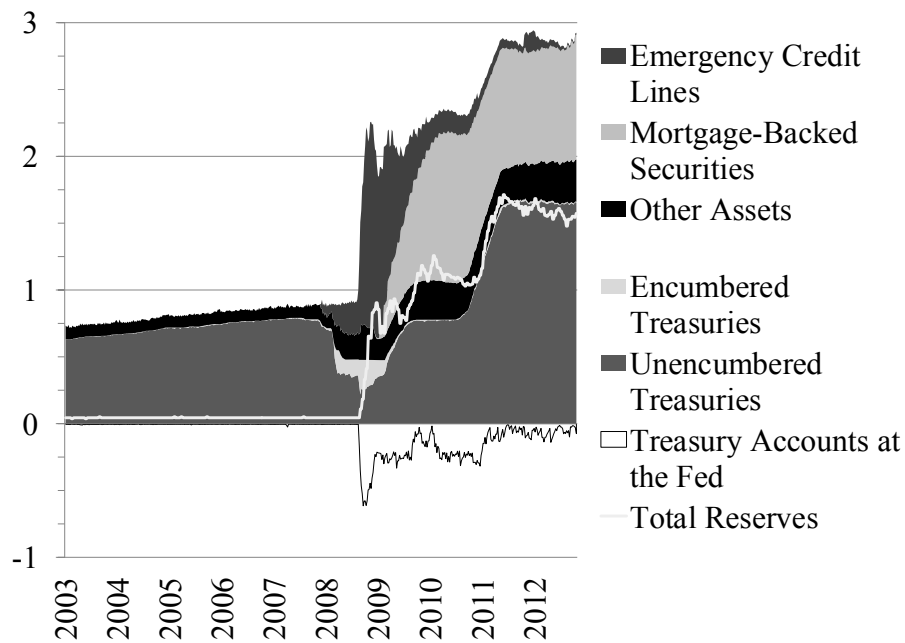
From what the preceding sections have shown, one can conclude that the Treasury has issued securities for purposes other than funding itself. One reason is to provide a means of payment to the country, the second is to help the Federal Reserve in its interest-rate stabilization operations, and the third is to help financial institutions meet their capital requirements and to provide a foundation upon which all other securities are valued, by providing a proxy for the risk-free rate. MMT argues that these reasons for issuing Treasuries are much more relevant in a monetarily sovereign government, because they do not result from a self-imposed constraint. They respond to a genuine need of the economic system unless interest is paid on reserves (with the rate varying with the maturity of the account, much like for traditional demand and savings deposits) and there is wide access to central bank accounts.

Figure 2. Treasury Accounts, Yearly Average (Billions of Dollars)



Source: Financial Management Service (United States Central Summary General Ledger Account Balances)

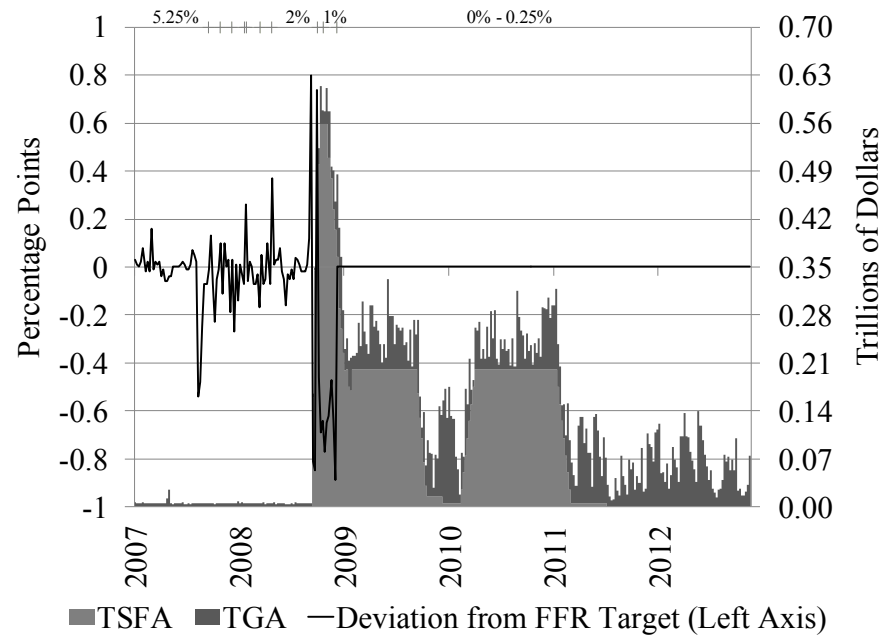
Figure 3. Federal Reserve Balance Sheet and Injection (+) and Drainage (-) of Reserves (Trillions of Dollars)



Note: Encumbered Treasuries include Treasuries lent overnight and through the TSLF.

Source: Board of Governors of the Federal Reserve System (H4.1, Tables 1 and 1A)

Figure 4. Amount of Reserves Drained by Treasury Operations, and Deviation from FFR Target



Note: Some FFR targets are shown at the top of the graph. Each separation represents a change in the target.

Sources: FRBNY; Board of Governors of the Federal Reserve System

IV. Funding of the Treasury

One conclusion of MMT is that Treasury spending always involves monetary creation as private bank accounts are credited, while taxation involves monetary destruction as bank accounts are debited. The question becomes how the Treasury acquired the funds it has in its TGA; the answer is through taxation and bond offerings. While economists usually stop here, MMT goes one step further and wonders where the funds for taxation and bond purchases came from; the answer is from the Federal Reserve. This must be the case, because, leaving aside TT&Ls, taxes and bond offerings drain reserves, so the Federal Reserve had to provide the funds. The logical conclusion, then, is that a reserve injection has to come before taxes and bond offerings. More broadly, the theoretical insight that MMT draws is that government spending (by the Treasury or the central bank) must come first; that is, it must come before taxes or bond offerings. Spending is done through monetary creation *ex nihilo*, in the same way a bank spends by crediting bank accounts; taxes and bond offerings lead to monetary destruction.

As the following shows, in practice, injections of reserves related to the Treasury have come in several forms: monetary creation by the Treasury, funding of the Treasury by the central bank, funding of primary dealers by the central bank, and maturation of Treasuries. The injection of reserves allows banks to buy Treasuries or to complete tax payments.

A. Funding constraints and means to bypass them

Under the current budgetary procedures, the Treasury must issue securities to economic units other than the Federal Reserve to be able to fund a deficit (provided there are not enough funds in the TGA and TT&Ls). The Treasury has at least four ways to bypass this budgetary procedure: (1) issue its own monetary instrument; (2) allow banks to buy Treasuries by crediting TT&Ls; (3) allow the Federal Reserve to provide a direct emergency or regular credit line to the Treasury; and (4) have the Federal Reserve indirectly provide funding to the Treasury through banks. The Treasury uses, or has used, all of these different techniques.

Regarding the first three methods to bypass the financial constraint, in the past the Treasury was responsible for a large quantity of the money supply, and it printed United States notes until the 1960s. Of course, coins are still issued by the Treasury, and it could stamp coins of any denomination. Beyond the issuance of monetary instruments, in the 1950s, the Treasury also issued tax anticipations bills similar to the ones issued by the Massachusetts colonies. The bills were accepted at face value for payments of income and profit taxes on a specific date. In addition, the Treasury allowed banks to pay for the new bills by crediting the TT&Ls. A central goal of allowing TT&Ls crediting was to coordinate with the Federal Reserve in order to maintain interest-rate stability, by preventing drainage of reverses from the sale of Treasuries:

The Treasury, on several occasions in the past, has permitted qualified depository banks to make payment by a credit to the Treasury's account on their own books. The purpose of this provision was to facilitate the marketing of new offerings at times when member bank reserves were subjected to abnormal pressures. (FRBR 1952, p. 7)

Monetary financing by the private banks occurred on a regular basis before 1929 through the war loan deposit accounts (the former name of TT&Ls) (Garbade 2008). This was not done at the discretion of banks; rather, it resulted when the Treasury told banks they could buy bills by crediting the bank account of the Treasury. The Treasury has not allowed banks do to this since October 1989 (US Treasury, 1989).

Beyond the issuance of monetary instruments and monetary financing by private banks, a third way for the Treasury to bypass its self-imposed financing constraints is through the direct involvement of the central bank. In the past, the central bank sometimes purchased Treasuries directly from the Treasury, either because an offering failed or because of a low TGA before tax receipts. Prior to 1935, there was no restriction on Treasuries purchases by the Federal Reserve, which could buy Treasuries directly from the Treasury or from the open market. The 1935 Banking Act amended section 14 of the Federal Reserve Act to prohibit the Federal Reserve from purchasing Treasuries directly from the Treasury. This was quite inconvenient for the Treasury, because:

Treasury has huge outpayments before tax receipts come in—we used to have securities maturing and interest due the 15th of March before the

taxes came in—and in the meantime we had an overdraft, we were busted, and the Federal Reserve used to lend us money at those times. (US Senate 1957, p. 897)

In order to bypass the 1935 constraint, the Treasury used the following financial trick:

Since under this law the Treasury could not borrow directly from the Federal [Reserve], we would sell to the commercial banks, participation in this overdraft. They would have lots of money, because we just had redeemed some securities and had not collected taxes. (US Senate 1957, p. 897)

By repaying some maturing securities, the Treasury provided the reserves needed by banks to purchase short-term certificates of indebtedness.

At the request of the Federal Reserve—which needed help to preserve stability in the money market—the 1942 Second War Powers Act removed the 1935 restriction, subject to re-approval by Congress every two years (BGFRS 1942; US House 1947; US Senate 1957). The Act allowed the outstanding amount of Treasuries directly purchased by the Federal Reserve to be, at most, \$5 billion at any time. This funding source was mainly used as an emergency source in case the amount of funds in the TGA became too small, and was not considered a central funding source by the Treasury:

The existence of the direct-purchase authority provides us with a margin of safety which permits us to let our cash balance fall to otherwise unacceptably low levels preceding periods of seasonally heavy revenues. . . . The direct-purchase authority is available to provide an immediate source of funds for temporary financing in the event of a natural emergency on a broader scale. While this has never happened, it is conceivable that financial markets could be disrupted at a time when large amounts of cash had to be raised to maintain governmental functions and meet the emergency. (Altman in US House 1978, p. 10)

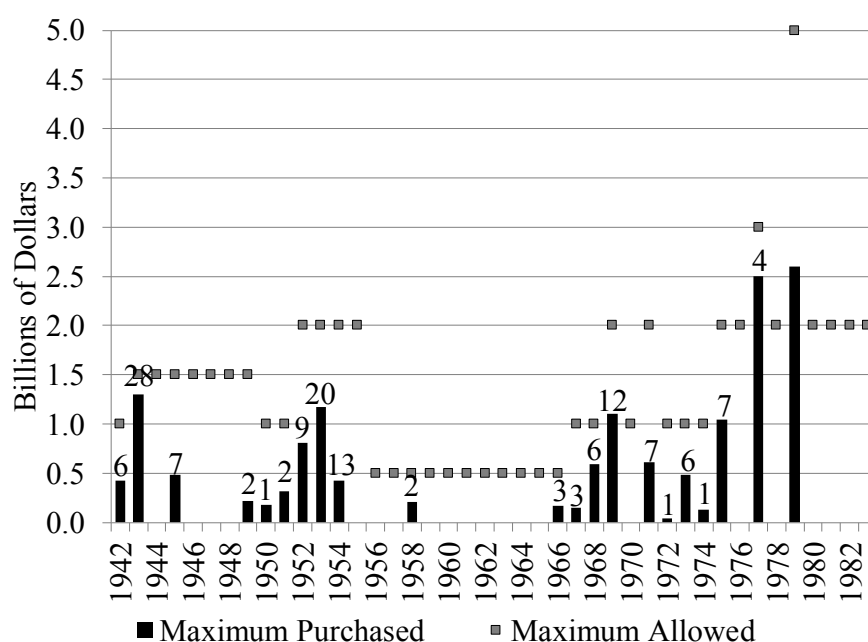
Chairman Martin provides the Federal Reserve's perspective on this funding facility for the Treasury:

The use of this authority by the Federal Reserve enables the Treasury to avoid creating unnecessary financial strains that would otherwise occur if it had to draw heavily on its accounts especially during periods immediately preceding tax payment dates. Temporary Treasury borrowing at such times, followed by prompt repayment from the proceeds of tax payments, provides a smooth operating mechanism, without the abrupt money market fluctuations that would otherwise occur. (Martin in US House 1962, p. 12)

One may note again that a central purpose of this funding channel was to avoid the potential adverse impact on the federal funds market from the need to replenish the TGA.

Figure 5 shows that the Treasury used this funding channel relatively rarely and usually for less than a week at a time. While \$5 billion was the maximum limit set by Congress, the Board of Governors had the discretion to set that limit lower. In practice, the maximum amount of “special short-term Treasury certificates” that the Federal Reserve was willing to buy varied between \$500 million and \$5 billion. The limit was set usually around \$1 billion or \$2 billion, but the Federal Reserve did move up the limit temporarily if needed by the Treasury. A June 8, 1979, act (Public Law 96-18) allowed this power of the Federal Reserve Bank to lapse after 1981, but the Board kept that power until the end of 1983 (BGFRS 1983).

Figure 5. Maximum Amount of Special Short-Term Treasury Certificates Purchased Directly from the US Treasury, Maximum Maturity (Days, Shown above Bar), and Maximum Outstanding Amount Allowed by the Board



Note: Maximum maturity is not available for 1979.

Sources: US Treasury (1978, p. 290); Annual Reports of the Board of Governors of the Federal Reserve System

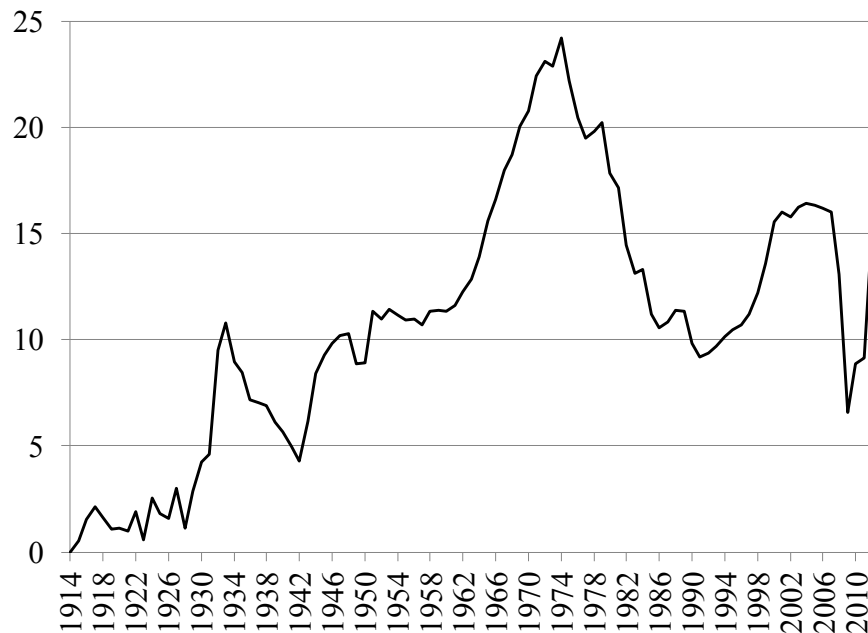
However, the end of this direct-purchase program was not a problem because, from the 1980s, this funding procedure became unnecessary as the Treasury coordinated with the Federal Reserve to keep around \$5 billion in its TGA at any time, and as Treasuries auctions became more successful. The Treasury took quite a long time to figure out how to offer properly its securities on the primary market. Well into the 1960s, the Federal Reserve would help by buying some bonds and notes in the primary market. A major reason why offerings were not successful had to do with the technique of issuance of bonds and notes,

for which auctioning was not well established until the 1970s. T-bills were never really a problem, since they immediately started to be issued at auction successfully (Garbade 2004, 2008; Hallowell and Williamson 1961).

Today, the most common way for the government to bypass the financing constraints is through a fourth artifact. Even though the Federal Reserve is not allowed to increase its holding of Treasuries by participating in the primary Treasuries market, it is indirectly involved in Treasury funding through three channels. First, it finances the primary dealers that participate in the Treasuries auctions, and it does so by accepting Treasuries as collateral for repos or by buying Treasuries outright. The Federal Reserve is a major holder of Treasuries, with usually over 10 percent of outstanding public debt held by the public in the portfolio of the Federal Reserve; see Figure 6. Second, the Federal Reserve is actively involved in setting the entire yield curve of Treasuries, either by focusing on the short end of the curve and influencing expectation about future short-term rates, or by buying and selling long-term Treasuries in the secondary market. Third, the Federal Reserve is still a major participant in the primary market because it buys new Treasuries to replace its maturing Treasuries, which helps to ensure that refinancing of the Treasury goes smoothly (Edwards 1997).

One can conclude from the previous points that there is nothing written in stone in terms of fiscal operations. If tomorrow nobody were willing to take Treasuries, the Treasury, with or without the help of the Federal Reserve, has the means to bypass that problem if it chooses to use them; it becomes a political issue, not an economic issue. The theoretical implication that MMT draws from this is that one can simplify the *economic* analysis without loss of generality by assuming that the Federal Reserve directly funds the Treasury.

Figure 6. Federal Reserve Portion of the Public Debt held by the Public (Percent)



Sources: Financial Management Service; Marshall (2002);
<http://www.usgovernmentdebt.us/>

B. Cost of public debt

In a monetarily sovereign nation, the government is able to have perfect control over the interest rate it pays on its debt. The government may choose not to use that power, but it is a self-imposed constraint; it is a political or policy decision, not an economic constraint. In practice, monetarily sovereign governments choose to go halfway: not perfectly controlling interest rates but also not letting them range out of control. This “semi-control” comes in three ways. One is through the bidding process in the primary market for Treasuries, another is through interest-rate-management strategies, and a third method is through debt management.

In a Treasuries auction, two types of bidding are possible: competitive and noncompetitive. Noncompetitive bidding means that participants in the primary market for Treasuries accept whatever discount rate is determined at the auction. This type of bidding was introduced in 1947 to widen the market for T-bills among small bidders. For competitive bids, the government set up the auction to get the highest possible price for its securities:

Since November 1998, all Treasury securities have been auctioned according to the uniform-price method. . . . Previously, most securities had been issued according to the multiple-price method, meaning that securities were awarded at prices corresponding to the yield of each successful competitive

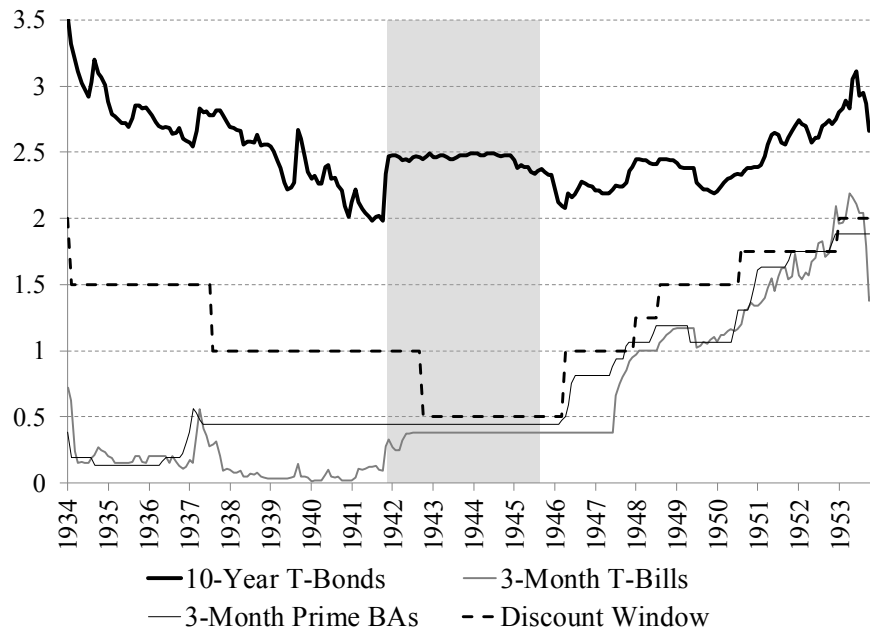
bid. In such auctions, bidders must be concerned with the “winner’s curse”—the tendency for a successful bidder to pay a price higher than the value assessed by other auction participants. By mitigating the winner’s curse, the uniform-price auction may elicit more aggressive bids, possibly increasing the Treasury’s revenue. (Dupont and Sack 1999, p. 788)

As noted earlier, it actually took quite a few decades for the Treasury to figure out the best offering mechanism, as oversubscriptions or auction failures were quite common until the 1970s. Moving from yield-auction instead of price-auction further improved the success of auctions, as did single-price auctions.

Beyond the auction mechanisms of Treasuries, the interest-rate policy of the Federal Reserve plays a crucial role in determining the level and slope of the yield curve on Treasuries through its current and expected FFR. Correlation between the FFR and T-bills is almost perfect, and correlation between the FFR and the T-bond rate is very high. The Federal Reserve can also decide to set the entire yield curve. For nine years (1937–45), the bankers’ acceptance rate (the equivalent of the FFR at the time) was set at $\frac{7}{16}$ of 1 percent (0.4375 percent); from 1942 to 1947, the T-bills rate was set at $\frac{3}{8}$ of 1 percent (0.375 percent), and the T-bond rate was set almost perfectly at 2.5 percent from 1942 to 1945 (Figure 7). The recent quantitative easing policy is another example of similar yield-curve targeting, albeit not as strong as during World War II.

Finally, the Treasury may improve the control over the cost of its debt by choosing the maturity it wants. If the Treasury wants to closely align its cost to the FFR, it may decide to issue only T-bills. In that case, the cost of the public debt will be under the control of the Federal Reserve. However, the Treasury usually also issues longer-maturity securities, partly to fulfill the needs of financial-market participants for long-term default-free liquid assets, and partly to avoid frequent refinancing at a higher interest rate if the FFR target goes up.

Figure 7. US Interest Rates in the 1930s, 1940s, and 1950s



Sources: NBER; Board of Governors of the Federal Reserve System

Note: Gray area is represents US involvement in World War II.

C. Public debt and debt limit

Beyond the prohibition of direct financing by the central bank, another major self-imposed constraint on the budgetary operations of the Treasury is that the US Congress must approve the issuance of additional Treasuries if the outstanding amount of Treasuries reaches a specific value—the “debt ceiling.” Given that Congress usually approves a budget that is in deficit, it must also periodically vote to raise the debt ceiling, but these two votes are taken separately. As the current situation in the United States shows, if there is no agreement to raise the debt limit, a deficit-spending budget cannot be implemented, because the Treasury is not allowed to issue more securities in order to obtain the funds needed to close its budget.

The public debt is the outstanding amount of US Treasury securities (USTS). It includes both marketable securities (mostly bills, notes, bonds, and TIPS) and nonmarketable securities (US notes, gold certificates, US savings bonds, Treasury demand deposits issued to states and local governments, and others). The public debt held by the public is the outstanding amount of USTS held by entities outside the US government. These entities include the Federal Reserve System, US states and municipalities, foreign governments, and the private sector.

If one looks more closely at how the public debt is measured, one can quickly note the arbitrary nature of this measure, and that the debt limit can be bypassed easily. For example, coins are not counted as part of the public debt because:

In this context it is critical to realize that the stock of reserves, or money, newly issued by the government is not a debt of the government. The reason is that fiat money is not redeemable, in that holders of money cannot claim repayment in something other than money. Money is therefore properly treated as government equity rather than government debt, which is exactly how treasury coin is currently treated under U.S. accounting conventions (Benes and Kumhof 2012, p. 6).

Unfortunately, this argument does not stand the ground of observation. The public debt does include a monetary instrument that has always been unconvertible—US notes—and two that were previously convertible but are no longer so—silver and gold certificates. The main difference between them and a Federal Reserve note is the color of the ink. Coins are similar to a US note; both are unconvertible monetary instruments issued by the Treasury, one in paper form, one in metal form.

One may observe that the accounting treatment of coins as equity and the exclusion of Federal Reserve notes from the definition of public debt leads to a straightforward solution to reduce the public debt: convert all outstanding red (US notes), blue (silver certificates), and yellow (gold certificates) currency into metal currency or green currency (Federal Reserve notes). Currently, that would eliminate \$422 million of public debt. However, this would not help deal with the debt-ceiling constraint because these components of the public debt are not subject to the debt limit, which leads us to another conclusion: in order to bypass the debt-ceiling problem, the Treasury just needs to issue zero-interest instantaneous-maturity securities (US notes and coins) instead of interest-paying securities or zero-coupon securities with a maturity higher than US notes.

If physical currency is too inconvenient for performing transactions, the Treasury can issue coins (or notes) of any denomination (like a trillion-dollar platinum coin) and transfer them to the Federal Reserve against credit at its TGA. Or the president can use section 4 of the 14th Amendment. Surely, there are other means to bypass this constraint, as long as the political will exists and the Treasury has used other accounting techniques to avoid default (Meulendyke 1998, p. 232n15).

V. Conclusion

This chapter has provided some evidence that the self-imposed constraints on the Treasury and Federal Reserve are quite loose, and that they have been bypassed easily when found to be too constraining or when the stability of the economy was a primary concern. In addition, they do not change the causalities at play or the impact on economic variables (i.e., interest rates, exchange rates, balance sheets, and national income), and so they are not relevant economic issues—even though they may be politically relevant. Finally, the financial operations of the Treasury and the central bank are so intertwined that both of them are constantly in contact in order to make fiscal and monetary policy run smoothly. The Treasury gets involved in monetary policy and the central bank gets involved in fiscal

policy. As such, the independence of the central bank is rather limited, and the central bank must ultimately support the Treasury in one way or another.

Bruce MacLaury of the Federal Reserve Bank of Minneapolis summarized all these points quite nicely:

The central bank is in constant contact with the Treasury Department, which, among other things, is responsible for the management of the public debt and its various cash accounts. Prior to the existence of the Federal Reserve System, the Treasury actually carried out many monetary functions. And even since, the Treasury has often been deeply involved in monetary functions, especially during the earlier years. . . . Following the 1951 accord between the Treasury and the Federal Reserve System, the central bank was no longer required to support the securities market at any particular level. In effect, the accord established that the central bank would act independently and exercise its own judgment as to the most appropriate monetary policy. But it would also work closely with the Treasury and would be fully informed of and sympathetic to the Treasury's needs in managing and financing the public debt. . . . The Treasury and the central bank also work closely in the Treasury's management of its substantial cash payments and withdrawals of Treasury Tax and Loan account balances deposited in commercial banks, since these cash flows affect bank reserves. (MacLaury 1977)

The central bank and the Treasury must work together to support the monetary and financial systems because they are ultimately two sides of the same coin, the government sector.

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CHAPTER 5. Central Bank Independence and Government Finance¹³³

L. Randall Wray

In previous chapters we have examined the principal changes in governance of the Fed over the century from its birth. We have also detailed the conflicts that emerged after World War II, and the famous Accord of 1951 that is believed by most to have ensured the Fed's independence from the Treasury. However, as we demonstrated, the protagonists in that "battle" saw this independence as situational and limited. In the last chapter, we cast some doubt on the degree to which self-imposed barriers actually keep "monetary" and "fiscal" operations separate. Among economists today, the main point of central bank independence is to prohibit "inflationary" money financing of treasury deficits. In this chapter we examine the "myth" of central bank independence from government finance.

I. Introduction

It has been commonplace to speak of central bank independence—as if it were both a reality and a necessity. Discussions of the Fed invariably refer to legislated independence and often to the famous 1951 Accord that apparently settled the matter.¹³⁴ While everyone recognizes the congressionally imposed dual mandate, the Fed has substantial discretion in its interpretation of the vague call for high employment and low inflation. For a long time economists presumed those goals to be in conflict but in recent years Chairman Greenspan seemed to have successfully argued that pursuit of low inflation rather automatically supports sustainable growth with maximum feasible employment.

In any event, nothing is more sacrosanct than the supposed independence of the central bank from the treasury, with the economics profession as well as policymakers ready to defend the prohibition of central bank "financing" of budget deficits. As in many developed nations, this prohibition was written into US law from the founding of the Fed in 1913. In practice, the prohibition is easy to evade, as we found during World War II in the United States when budget deficits ran up to a quarter of GDP.¹³⁵ If a central bank stands ready to buy government bonds in the secondary market to peg an interest rate, then private entities will buy bills and bonds in the new issue market and sell them to the central bank at a virtually guaranteed price. Since central bank purchases of Treasuries supply the reserves needed by banks to buy treasury debts, a virtuous circle is created so that the

¹³³ This chapter draws on "Central Bank Independence: Myth and Misunderstanding" by L. Randall Wray, Working Paper No. 791, Levy Economics Institute of Bard College, March 2014

¹³⁴ See Thorvald Moe's chapters above on the role of Eccles and the discussions and events that led up to the 1951 Accord. Moe makes a strong case that the vision of Eccles was instrumental in that evolution; as we will see, modern theories of central banks, however, deviate sharply from the Eccles vision in quite illuminating ways.

¹³⁵ As Moe argues above, the Fed ended up owning virtually all the bills issued in the 1940s.

treasury faces no financing constraint. As discussed in the chapters above, that is in large part what the 1951 Accord was supposed to end: the cheap source of US Treasury finance.

Since the global financial crisis hit in 2007, these matters have come to the fore in both the US and the European Monetary Union. In the United States, discussion of “printing money” to finance burgeoning deficits was somewhat muted, in part because the Fed purportedly undertook quantitative easing (QE) to push banks to lend—not to provide the Treasury with cheap funding. But the impact has been the same as World War II-era finances: very low interest rates on government debt even as a large portion of the debt ended up on the books of the Fed, while bank reserves have grown to historic levels (the Fed also purchased and lent against private debt, adding to excess reserves—as discussed in our report last year). While hyper-inflationists have been pointing to the fact that the Fed is essentially “printing money” (actually reserves) to finance the budget deficits, most other observers have endorsed the Fed’s notion that QE might allow it to “push on a string” by spurring private banks to lend—which is thought to be desirable and certainly better than “financing” budget deficits to allow government spending to grow the economy. Growth through fiscal austerity is the new motto as the Fed accumulates ever more federal government debt and mortgage-backed securities.

The other case is in the EMU, where the European Central Bank had long been presumed to be prohibited from buying debt of the member governments. By design, these governments were supposed to be disciplined by markets, to keep their deficits and debt within Maastricht criteria. Needless to say, things have not turned out quite as planned. The ECB’s balance sheet has blown up just as the Fed’s did—and there is no end in sight in Euroland, even as the Fed has begun to taper. It would not be hyperbole to predict that the ECB will end up owning (or at least standing behind) most EMU government debt as it continues to expand its backstop.

It is, then, perhaps a good time to reexamine the thinking behind central bank independence. There are several related issues.

First, can a central bank really be independent? In what sense? Political? Operational? Policy formation?

Second, *should* a central bank be independent? In a democracy should monetary policy—purportedly as important as or even more important than fiscal policy—be unaccountable? Why?

Finally, what are the potential problems faced if a central bank is not independent? Inflation? Insolvency?

While this chapter will focus on the United States and the Fed, the analysis is relevant to general discussions about central bank independence. We will limit our analysis to the questions surrounding what we mean by central bank independence in what sense is the Fed independent. We leave to our next report the questions surrounding the wisdom of granting independence to the Fed, democratic accountability, and potential reforms. We

will argue here that the Fed is independent only in a very narrow sense. We have argued in our two previous reports that the Fed's crisis response during the global financial crisis (GFC) does raise serious issues of transparency and accountability—issues that have not been resolved with the Dodd-Frank legislation.¹³⁶ Finally, it will become apparent that we do not believe that lack of central bank independence raises significant problems with inflation or insolvency of the sovereign government.

For the US case we will draw on the excellent study of the evolution of governance of the Fed by Bernard Shull in Chapter 1 above.¹³⁷ As we will see, the dominant argument for independence throughout the Fed's history has been that monetary policy should be set to promote the national interest. This requires that it should be free of political influence coming from Congress. Further, it was gradually accepted that even though the Federal Open Market Committee (FOMC) includes participation by regional Federal Reserve Banks, the members of the FOMC are to put the national interest first. Shull shows that while governance issues remain unresolved, Congress has asserted its oversight rights, especially during war and in economic or financial crises.

We will also include summaries of the arguments of two insiders—one from the Treasury and the other from the Fed—that also conclude that the case of the Fed's independence is frequently overstated. The former Treasury official argues that at least within the Treasury there is no presumption that the Fed is *operationally* independent. The Fed official authored a comprehensive statement on the Fed's independence, arguing that the Fed is a creature of Congress. More recently, former Chairman Bernanke has said that “of course we'll do whatever Congress tells us to do”: if the Congress is not satisfied with the Fed's actions, the Congress can always tell the Fed to behave differently.¹³⁸

In the aftermath of the GFC, Congress has attempted to exert greater control with its Dodd-Frank legislation. The Fed handled most of the US policy response to the Great Recession (or, GFC). As we have documented, most of the rescue was behind closed doors and intended to remain secret.¹³⁹ Much of it, at least, stretched the law and perhaps went beyond the now-famous section 13(3), which had been invoked for “unusual and exigent”

¹³⁶ See the two previous annual reports of research conducted with the support of the Ford Foundation: L. Randall Wray, “Improving Governance of the Government Safety Net in Financial Crisis,” Research Project Report, Levy Economics Institute of Bard College, April 2012, http://www.levyinstitute.org/pubs/rpr_04_12_wray.pdf; and L. Randall Wray, “The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention after 2007,” Research Project Report, Levy Economics Institute of Bard College, April 2013, <http://www.levyinstitute.org/publications/?docid=1739>.

¹³⁷ The chapter above draws on Bernard Shull, “Financial Crisis Resolution and Federal Reserve Governance: Economic Thought and Political Realities,” Working Paper No. 784, Levy Economics Institute of Bard College, January 2014.

¹³⁸ See his statement here: <http://www.youtube.com/watch?v=a7XV3vS1hAM>.

¹³⁹ See James A. Felkerson, “A Detailed Look at the Fed's Crisis Response by Funding Facility and Recipient,” Public Policy Brief No. 123, Levy Economics Institute of Bard College, April 2012, http://www.levyinstitute.org/pubs/ppb_123.pdf; and Wray, “Improving Governance of the Government Safety Net in Financial Crisis.”

circumstances for the first time since the Great Depression. Congress has demanded greater transparency and has tightened restrictions on the Fed's future crisis response. Paradoxically, Dodd-Frank also increased the Fed's authority and responsibility. However, in some sense this is "déjà-vu" because congressional reaction to the Fed's poor response to the onset of the Great Depression was similarly paradoxical, as Congress simultaneously asserted more control over the Fed while broadening the scope of the Fed's mission.

II. Independent of What?

Most references to central bank independence are little more than vague hand waves. In the United States, the Fed is a "creature of Congress," established by the Federal Reserve Act (FRA) of 1913, which has been modified a number of times. Elected officials play a role in selecting top Fed officials. And while the Fed is nominally owned by shareholding banks, and while the Fed's budget is separate, profits above 6 percent on equity are returned to the Treasury. Congress also has asserted its authority to mandate that the Fed release detailed information on its operations and budget—and there seems to be nothing but congressional timidity to stop it from demanding more control over the Fed (indeed, Dodd-Frank sanctions many of the actions taken by the Fed during the GFC, now requiring prior approval by the president, the treasury secretary, and/or Congress for various types of interventions).

Further, as we will see, the Fed's operations are necessarily closely coordinated with the Treasury's; the Fed, after all, functions as the Treasury's bank. Finally, as everyone knows, Congress has provided a dual mandate to guide Fed policy, although one could easily interpret congressional will as consisting of four (at least some of which are related) mandates: high employment, low inflation, acceptable growth, and financial stability.

The Fed is a creature of Congress. Bruce MacLaury of the Minneapolis Fed put the relationship this way:¹⁴⁰

Ultimately the [Federal Reserve] System is accountable to congress, not the executive branch, even though Reserve Board members and the chairman are president-appointed. The authority and delegated policy powers are subject to review by the congress not the president, the Treasury Department, nor by banks or other interests. (MacLaury 1977)

¹⁴⁰ See Bruce K. MacLaury, "Perspectives on Federal Reserve Independence—A Changing Structure for Changing Times," in Federal Reserve Bank of Minneapolis, *Annual Report 1976*, January 1, 1977, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=690, which examines Fed independence with respect to Congress, the executive branch (including the Treasury), member banks, and within itself (e.g., relations between the Board of Governors in Washington and the District Banks). Note that in many ways MacLaury echoes what was said by Fed officials, including Eccles, around the time of the 1951 Accord—see chapters 2 and 3 above.

While many supporters and critics alike have stressed the Fed's nominal ownership by member banks as evidence that it is somehow independent of government, MacLaury interprets the independence as follows:

First, let's be clear on what independence does not mean. It does not mean decisions and actions made without accountability. By law and by established procedures, the System is clearly accountable to congress—not only for its monetary policy actions, but also for its regulatory responsibilities and for services to banks and to the public. Nor does independence mean that monetary policy actions should be free from public discussion and criticism—by members of congress, by professional economists in and out of government, by financial, business, and community leaders, and by informed citizens. Nor does it mean that the Fed is independent of the government. Although closely interfaced with commercial banking, the Fed is clearly a public institution, functioning within a discipline of responsibility to the “public interest.” It has a degree of independence within the government—which is quite different from being independent of government. Thus, the Federal Reserve System is more appropriately thought of as being “insulated” from, rather than independent of, political—government and banking—special interest pressures. Through their 14-year terms and staggered appointments, for example, members of the Board of Governors are insulated from being dependent on or beholden to the current administration or party in power. In this and in other ways, then, the monetary process is insulated—but not isolated—from these influences. In a functional sense, the insulated structure enables monetary policy makers to look beyond short-term pressures and political expedients whenever the long-term goals of sustainable growth and stable prices may require “unpopular” policy actions. Monetary judgments must be able to weigh as objectively as possible the merit of short-term expedients against long-term consequences—in the on-going public interest.

We can take that as our starting point: the Fed is part of government—a public institution—but is insulated from day-to-day politics and other types of special interest pressures. Let's explore this independence in more detail, beginning with an historical perspective.

A. Fed governance: Historical perspective

In chapter 1, Shull offers a detailed history of the evolution of Fed governance. He notes that the Fed is an independent government agency like the Federal Trade Commission, the National Labor Relations Board, and the Securities and Exchange Commission. Each of these has substantial discretion in implementing laws through rules and regulations and in formulating policies. Most independent agencies have an inspector general and are subject to congressional oversight. The Fed is somewhat unusual in that it is self-financing, and in that there is a widely held belief that if its formulation of monetary policy were not

independent, the *policy outcome* would be worse. In other words, good monetary policy supposedly depends on independence (from Congress and the administration). Thus, the Fed's monetary policy is not subject to audit by the General Accountability Office—and courts have refused to hear suits that accuse the Fed of policy mistakes. In recent decades, the administration has been reluctant even to criticize the Fed's monetary policy. However, as we saw in chapters 2 and 3 above, that has not always been the case.

The movement to create a central bank strengthened after the Panic of 1907. Rival plans were put forward, ranging from a bank-supported plan that would create a privately owned central bank (like the Bank of England), to a proposal to house the US central bank within the Treasury. The Glass-Owen bill split the difference, with private ownership and a decentralized system, but with the treasury secretary and the comptroller of the currency sitting on the Federal Reserve Board. The decentralized system was supposed to ensure “fair representation of the financial, industrial and commercial interests and geographic divisions of the country,” and the Board was to be “a distinctly nonpartisan organization and was to be wholly divorced from politics” (quoted in Shull, chapter 1 above).

When World War I came along, however, the Fed turned its attention to supporting the Treasury's debt issue. In the inflationary period at the end of the war, the regional Feds raised discount rates sharply (up to 85 percent) and a deep retraction followed that led to deflation of farm prices. Congress revisited the governance issue as some critics wanted to force the Fed to seek congressional approval in advance of future rate hikes. One of the Board members, Adolph Miller, understood the implication:

The American people will never stand contraction if they know it can be helped. Least of all will they stand contraction if they think it is contraction at the instance, or with the consent of an institution like the Federal Reserve System. . . . The Reserve System cannot “make” the business situation but it can do an immense deal to make its extremes less pronounced and violent. . . . Discount policy . . . should always address itself to the phase of the business cycle through which the country happens to be passing. (Quoted in Shull, chapter 1 above)

As Shull argues, the governance by “paralyzing checks and balances” conflicted with the need to cooperate to use monetary policy to stabilize the economy. Congress tightened the reins on the Fed but also centralized decision making at the Board in Washington. The GAO began to audit the Board, and there were a number of commissions and committees that investigated new guidelines to control the Fed. However, the 1927 Pepper-McFadden Act replaced the Fed's original 20-year charter with an indefinite charter, and a congressional report at the time declared that the Fed had demonstrated its usefulness. In the end, congressional anger dissipated and not much was done to constrain the Fed's discretion.

Governance issues again came to the forefront during the Great Depression, with serious consideration given to government ownership of the Fed, to be housed in the Treasury. President Roosevelt (who seemed to have supported such a move), as well as many in Congress, was concerned that the Fed was not sufficiently attuned to the national interest.

Title II of the Banking Act of 1935 was a compromise that preserved private ownership but moved to ensure the Board would be more responsive to the national interest. (See chapters 1–3 above.) As power was further centralized in Washington, the “checks-and-balances” approach to governance continued to fade.

As in World War I, World War II saw the Fed cooperating with Treasury, in the national interest to keep rates on national debt low; the Korean War continued in the same vein. That ended in the famous Accord of 1951 discussed in the previous chapters, restoring the “independence” of the Fed to formulate monetary policy. However, policy was still to be undertaken in the national interest, with the Fed keeping rates very low until the mid 1960s; the Fed mainly operated in short-term Treasury bills so as to have minimum effects on other financial markets. Monetary policy remained on the back burner until the inflation-recession cycle of the early 1970s. In 1975, Congress decided to exert greater control, in House Resolution 113: that promotes “maximum employment, stable prices, and moderate long term interest rates” (Shull, chapter 1 above).

In the Federal Reserve Reform Act of 1977, the Senate insisted on the requirement that it confirm the president’s appointment of the Fed’s chairman and vice chairman. In addition, Congress required that Class B Reserve Bank directors had to be “elected to represent the public” (Shull, chapter 1 above). The 1978 Humphrey-Hawkins Full Employment and Balanced Growth Act clarified the Fed’s mandates and required semiannual reports to both the Senate and the House. Later, after Chairman Greenspan got caught in “white lies” provided to Chairman Gonzalez, the Fed was required to release its transcripts of FOMC meetings (albeit with a five-year lag).¹⁴¹ The Fed also voluntarily agreed to measures designed to increase transparency (including announcing its explicit interest rate target).

The final big changes to governance occurred after the GFC, when Dodd-Frank tightened limits on what the Fed can do in response to a crisis. This was a surprising turn of events, as Chairman Greenspan had become the darling of Congress and the media, and his replacement, Chairman Bernanke, had declared the era of the New Moderation, in which central bankers could do nothing wrong. However, in the aftermath of the crisis, many elected representatives as well as the media and the population at large blamed the Fed for the crisis, and for bungling a response that made the downturn worse than it should have been.¹⁴² As we’ve argued elsewhere, even many of those directly involved agreed that the Fed’s crisis response “stunk” and that it should never be repeated.¹⁴³ The Dodd-Frank Act was designed in part to ensure it would not happen again.

¹⁴¹ See L. Randall Wray, “The Fed and the New Monetary Consensus: The Case for Rate Hikes, Part Two,” Public Policy Brief No. 80, Levy Economics Institute of Bard College, December 2004, p. 14, for a discussion of this episode. The main authority on this affair is Robert Auerbach; see Appendix C to our 2012 report.

¹⁴² While we do not necessarily agree with those assessments, we do believe the Fed’s response does raise serious issues regarding democratic governance and transparency.

¹⁴³ See Wray, “The Lender of Last Resort,” the second report of this Ford Foundation-funded project, cited above.

However, yet again, Congress actually extended Fed responsibility, to include authority over large, systemically important nonbank financial institutions. Still, the Act restricted application of section 13(3) in future crises, and for some actions required approval from the Treasury. It also mandated increased transparency (including a review by the GAO of all the Fed's emergency assistance after the GFC). Congress also created the Financial Stability Oversight Council that is chaired by the treasury secretary and includes heads of agencies involved in overlooking the financial sector—including the Fed. In that manner, it diluted the Fed's power somewhat. Exactly what difference all this will make for the response in the next crisis cannot be foreseen in advance.

B. Independent from Congress: Discretion in selecting tools

The strongest case for Fed independence would be in its discretion to choose the tools and targets to pursue those congressional mandates. Congress has shown little interest in interfering with the details of monetary policy implementation, preferring only to mandate the ultimate goals. The period from 1979 to the mid-1980s was an exception, as Congress had become enamored with Milton Friedman's monetarist focus on growth of the money supply. Even after the Fed had dropped money growth targets from serious consideration, Congress still wanted the Fed to provide them. However, for the most part, Congress leaves these details to the Fed.

If we recall the old textbooks, there was a distinction among tools, targets, and goals. Goals are usually defined in terms of unemployment, inflation, and growth; in the case of the United States, there is the dual (or quadruple) mandate, but it is itself vague. The Fed does not set specific goals (i.e., specific inflation rates or unemployment rates), although a number of central banks have adopted narrow ranges for acceptable inflation rates. In that case, there is a synthesis of target and goal—the central bank targets an inflation rate that serves as a measure of monetary policy success; employment and output growth are then expected by-products of hitting the inflation target.

However, the Fed has not followed that practice, preferring greater discretionary leeway. Since inflation, by itself, would not seem to be a sufficient goal of policymaking, either the inflation target could be changed if it were inconsistent with other goals, or the other goals would be moved to the sphere of fiscal policy. The less extreme policy (and the one adopted in the United States) is to target “the” interest rate to hit the goals. In practice there are many interest rates, so central banks typically target the overnight interbank rate (the fed funds rate in the United States) with a view to affecting other market rates. However, as there is no close correspondence between “the” interest rate and the congressionally mandated goals (that are themselves vague), the Fed has a great deal of discretion over its setting of the interest rate target. In practice, almost any rate target could be justified as consistent with the goals.

The old monetarist preference was instead for a quantitative target (reserves) that would allow the central bank to control money growth. That was then supposed to allow the central bank to keep inflation low—although monetarists generally argued against

accelerating inflation rather than against inflation per se, as the economic costs of a low-to-moderate but stable inflation rate were not believed to be high. In any case, except where legislative mandate sets an inflation target, central banks are typically left to choose their targets (except when it comes to war finance—as discussed in chapters 2 and 3). Modern central banks have dropped monetary (quantitative) targets in favor of interest rate (price) targets—both because they are easier to hit and because current thinking is that they are more reliably linked to the goals.

That then leaves the policy tools available: open market operations and discount window lending rates. Again, these typically are seen to be within the discretion of the central bank. In the case of the United States, the early Fed relied on the discount window until it “discovered” open market effects on bank reserves; there was a debate in the early postwar period about the relative advantages of each (with Hyman Minsky arguing forcefully for reliance on the discount window rather than open market operations—and monetarists taking the opposite position), largely decided in favor of open market operations.

The dominance of that “market” approach was all the more obvious in the GFC, as the Fed created an alphabet soup of facilities to provide reserves “to the market” through auctions rather than lending them to banks at the discount window. The argument has long been that forcing banks to the discount window penalizes them through demonstration effects, or “frown costs.” (Canada has for some time offered an alternative, in which the central bank pays interest on positive reserve balances and charges an overdraft fee for banks that are short; there are presumably no “frown costs,” as banks attempt to maintain zero overnight reserve balances and simply borrow them as necessary to meet clearing.) During the debate in the 1960s, monetarists preferred open market operations on the belief that this better protects market forces—to allocate reserves and also to determine interest rates. However, if the Fed sets the discount rate and announces a fed funds rate target, the market is not setting those rates. Still, the way the Fed auctioned reserves during the crisis would seem more consistent with the market-based approach.

In conclusion, “independence” could refer to choice of tools—discount window versus open market purchases to supply reserves, discount window or overnight markets to determine interest rates, and required reserve ratios to determine deposit multipliers.

C. Independence from the Treasury: Fiscal and monetary policy operations

The United States got its central bank only in 1913, although it had brief experiments with the First and Second Banks of the United States as well as with special rights granted to national banks. With those exceptions, the Treasury, itself, provided most of the central banking functions until the Federal Reserve Act of 1913 created the Fed. MacLaury summarizes the evolution of Fed and Treasury sharing of responsibilities as follows:

The central bank is in constant contact with the Treasury Department, which, among other things, is responsible for the management of the public debt and its various cash accounts. Prior to the existence of the Federal Reserve

System, the Treasury actually carried out many monetary functions. And even since, the Treasury has often been deeply involved in monetary functions, especially during the earlier years. At the beginning of World War II, it appeared desirable that the Treasury be able to issue debt at relatively low interest cost and also on a basis that assured purchasers that securities would be marketable at near face value. Because of the urgency of this need, the policy was agreed to and continued after the war until 1951. During this period, the Treasury was, in effect, deciding the monetary policy of the country as it made its decisions as to how much debt needed to be funded. Because the central bank supported the market for government securities, it was forced to purchase amounts of securities necessary to maintain low interest rates and the par value of securities. Thus, as the Treasury issued additional debt, the central bank was forced to acquire part of that debt. This process resulted in direct addition to bank reserves. Following the 1951 accord between the Treasury and the Federal Reserve System, the central bank was no longer required to support the securities market at any particular level. In effect, the accord established that the central bank would act independently and exercise its own judgment as to the most appropriate monetary policy. But it would also work closely with the Treasury and would be fully informed of and sympathetic to the Treasury's needs in managing and financing the public debt. In fact, in special circumstances the Federal Reserve would support financing if unusual conditions in the market caused an issue to be poorly accepted by private investors. The Treasury and the central bank also work closely in the Treasury's management of its substantial cash payments and withdrawals of Treasury Tax and Loan account balances deposited in commercial banks, since these cash flows affect bank reserves.¹⁴⁴

In modern theory, central bank independence seems to refer additionally to operational independence. As discussed, the central bank of developed nations is often prohibited from directly financing government budget deficits—as in the United States, where the FRA mandated a separation of fiscal finances from central bank operations. This is a deviation from the traditional role of the first central banks, which were quite explicitly created to provide state finance. And as MacLaury explains above, the Fed returned to that central role in World War II (as it had done in World War I), but the Accord restored the separation. As a result, in the United States, the Treasury is required to make deposits to its account at the Fed before it can write checks (today, Treasury spending is increasingly accomplished through electronic payments, but that amounts to the same thing). Still, as MacLaury makes clear, the Fed works closely with the Treasury to ensure that fiscal operations proceed smoothly. If they did not, one can presume that the Fed and Treasury would cooperate to change the procedures.

¹⁴⁴ See MacLaury, “Perspectives on Federal Reserve Independence.”

The Treasury and the central bank also work closely in the Treasury's management of its substantial cash payments and withdrawals of Treasury tax and loan account balances deposited in commercial banks, since these cash flows affect bank reserves. Most economists seem to think that this constrains the Treasury—since it cannot spend unless it has deposits at the Fed.

Frank N. Newman, former deputy secretary of the US Treasury, shed light on the way the Treasury views constraints on financing its deficits:

I recall from my time at the Treasury Department that the assumption was always that there was money in the fed account to start with. Nobody seemed to know where it came from originally or when; perhaps it was established in biblical times. But as a matter of practice, if the treasury wanted to disburse \$20bn a given day, it started with at least that much in its fed account. Then later would issue new treasuries and rebuild its account at the fed. (I do not recall ever using an overdraft.)

In my view, this is still consistent with the MMT [modern money theory¹⁴⁵] perspective that you mentioned, and in my own book the explanation starts the cycle with government spending, thus adding to the money supply, and then issuing treasuries for roughly equivalent amount, thus restoring the money supply and the Treasury's Fed account to the levels they were prior to that round of spending. Every cycle is: spend first, then issue treasuries to replenish the fed account. The fact that Treasury started the period with some legacy funds in its Fed account is not really relevant to understanding the current flow of funds in any year.

(In practice, Treasury varies its issuance not only to match outlays, but also to deal with seasonal factors, and to avoid wide swings in new-issue sizes; so at one point of a year, treasury might actually issue some extra securities because the next month was expected to have low tax revenues, or might not fully replenish recent spending because the next month was expected to have high tax revenues. That seasonal process doesn't really affect the overall flow of funds over a year. The substance of the cycle is still: spend then replenish. Debating that would seem highly philosophical, and would miss the practical aspects of the flows.)

In any case, the treasury can always raise money by issuing securities. The bond vigilantes really have it backwards. There is always more demand for treasuries than can be allocated from a limited supply of new issues in each auction; the winners in the auctions get to place their funds in the safest most liquid form of instrument there is for US dollars; the losers are stuck keeping some of their funds in banks, with bank risk.

¹⁴⁵ See chapter 4 above for more discussion of the MMT approach.

(I even try to avoid using the expression “borrow” when the treasury issues securities; the treasury is providing an opportunity for investors to move funds from risky banks to safe and liquid treasuries.)¹⁴⁶

The precise operating procedures used have actually changed substantially over the years, and there is no reason to suppose that these changes were not made to facilitate fiscal operations. Generally speaking, the Treasury receives payments (mostly taxes) in its deposit accounts held at private banks, then shifts them to the Fed in order to spend. The Fed debits the reserves of the private banks when the deposits are shifted. Treasury spending reverses that, as reserves are credited to banks receiving deposits (recipients of Treasury spending). If all of this were accomplished instantaneously, it is obvious that the operations net out if the Treasury’s spending equals its tax receipts. In that case, there is no impact on private bank reserves or deposits. If, however, tax receipts are less than government spending, bank deposits and reserves would be net credited. When tax receipts are greater than government spending, there need not be any net impact on private bank reserves and deposits so long as the Treasury does not move its extra receipts to the Fed. In practice, the Treasury attempts to maintain a constant (small) positive account balance at the Fed, which ensures that fiscal operations do not affect private bank and reserve balances (since only changes to the Treasury’s deposit at the Fed would affect bank reserves).

According to MacLaury,

When the balance between spending and taxation results in government deficits, the Treasury has to issue additional public debt. In a monetary sense, the failure to tax adequately to cover the expenditures of the Federal government is an invitation for “printing money” through the issuance of federal debt. Depending on the phase of the business cycle, this tends to increase the money supply and, without offsetting action by the central bank, can result in an inflationary rise in prices. The result is “hidden taxation”—which takes away from taxpayers in the form of lower purchasing power (higher prices) what they would have paid in additional taxes had the expended funds been obtained through that source. Thus there is an important linkage between the taxing and spending powers of Congress and the monetary powers as delegated to the Federal Reserve System. In principle, it is the job of Congress and the executive branch jointly to define the economic policy objectives of our national government, and to support those objectives with appropriate fiscal measures. Then the central bank can coordinate monetary policy in a manner which serves those national objectives. When fiscal policy does not match spending appropriately to tax revenues, then the monetary authority is faced with a difficult choice: (a)

¹⁴⁶ From Stephanie Kelton, “Former Dept. Secretary of the U.S. Treasury Says Critics of MMT Are ‘Reaching,’” *New Economic Perspectives*, October 30, 2013.

how severely should it restrain the inflationary forces that may develop, and (b) to what extent should it permit inflationary forces to have their effect in higher prices? When the failure to provide appropriate tax revenues generates acute forces of inflation, then even the best compromise may require severe monetary restraint. This has the effect of appearing to be at cross-purposes with congressional intent and can also produce severe disruptions in some areas of the private sector such as housing.

Note that MacLaury does not imply that the Fed might try to prevent the Treasury from deficit spending; rather, the Fed's "independence" is strictly limited to its decision over whether to tighten monetary policy to fight any inflationary pressures that the deficits might fuel. While MacLaury was writing in a time in which it was believed that tight policy means slowing money growth, we now associate policy tightening with raising the interest rate target. Still, the important point is that when read together with the previous quotes from MacLaury and Newman, we presume that the Fed is to cooperate with the Treasury so that the fiscal operations proceed smoothly. The Fed's choice is not to refuse to "cut checks" so that the Treasury can spend funds allocated by Congress, but rather to tighten policy if it believes fiscal policy is too expansive.¹⁴⁷

How do the Treasury and Fed ensure that budget deficits over a time period (spending greater than receipts) do not affect bank reserves and deposits? The key is "debt management": new issues of Treasuries by the Treasury and/or open market sales by the Fed. As mentioned, there have been significant operational changes over the years, but conceptually, it is not difficult to understand the balance sheet operations that need to take place. To spend more than tax receipts, the Treasury needs additional deposits in its accounts at private banks—to be shifted to the Fed before spending. That can be accomplished by selling new Treasuries to banks, which would credit the Treasury's deposits. However, when the Treasury shifts deposits, the Fed needs to debit bank reserves. Since in normal times banks do not operate with excess reserves (today, of course, they have massive excess reserves as a result of three phases of quantitative easing), they do not have the extra reserves needed. The Fed can either lend the reserves or it can buy Treasuries in open market operations.

Note that if it were to buy Treasuries, it would need to buy the quantity of Treasuries the Treasury had just sold! While the Fed would not have violated the "independence" provided by the prohibition on direct purchases of Treasury debt, it would end up with the Treasury's debt anyway. While the Fed can choose whether to use open market operations or the discount window, it really cannot refuse to supply the reserves. First, that would cause bank reserves to go below desired or required reserves (assuming they were operating without excess reserve positions). But more important, it would cause the fed

¹⁴⁷ We leave to the side the question whether "tightening" by the Fed—raising interest rates—really does counter expansive fiscal policy. As those involved in the debate that preceded the Accord recognized, higher interest rates increase Treasury "costs"—spending on interest. That will be received as interest income and (probably) will result in bigger deficits (hence, "expansionary" fiscal policy).

funds rate to rise above target. If a central bank targets overnight rates, it must accommodate demand for reserves. This, of course, was the main complaint in the discussion that led up to the Accord: the low interest rate “peg” resulted in growing bank reserves when the government was running a budget deficit that generated more bonds than banks wanted to hold at the low rates.

In other words, the central bank’s “independent” interest rate setting conflicts with its “independence” from fiscal operations in the sense that it must provide the reserves banks will need when the Treasury moves the proceeds from a bond sale to its account at the Fed in order to make payments. When the Treasury does spend these proceeds, the deposits and reserves of banks are restored. At this point, the Fed will need to reverse its previous operation: banks will now have excess reserves that can be drained either through an open market sale of Treasuries by the Fed (i.e., the Fed sells the Treasuries it just bought) or the Fed and banks wind down discount window loans. (Note that the Fed for some time has used repos and reverse repos rather than outright sales and purchases, which ensures actions can be quickly reversed to minimize Treasury’s operational impacts on bank reserves.)

At the end of this process we find that deficit spending by the Treasury results in higher private bank deposits as well as greater Treasury holdings. (Note that it does not matter whether banks sell the Treasuries to households—in that case, bank holdings of Treasuries as well as bank liabilities to households are reduced by the amount of the sale; the Treasuries will be in household portfolios rather than in bank portfolios.) All of this is just a logical explication of the balance sheet operations that would need to occur given the twin constraints that the Treasury cannot sell bonds directly to the central bank and that it needs to move deposits from private banks to the central bank before spending.

In practice, there are many other ways fiscal operations could be accomplished. If the Treasury sold bonds directly to the Fed, the private banks would not need to act as intermediaries: the Fed would credit the Treasury’s account directly, and Treasury spending would lead to private bank deposits and reserves increasing. To drain the reserves created, the Fed would sell on the bonds it had just bought. The end result would be as described above. Note that the same thing could be accomplished if the Fed allowed the Treasury to run an “overdraft” on its account. In that case, the Treasury would cut a check and a private bank would credit the account of the recipient, and the Fed would credit the bank’s reserves. At that point there would be excess reserves in the banks that could be drained by a bond sale by the Treasury (new issue) or an open market sale by the Fed. The first would allow the Treasury to eliminate its overdraft; the second would move the Treasury debt off the Fed’s balance sheet and into the nongovernment sector.

Or, the Fed could provide the overdrafts to banks by allowing “float” to simplify the process. In that case, the banks buy bonds issued by the Treasury and credit the Treasury’s account; when the Treasury transfers its funds to the Fed, the Fed does not debit bank reserves, on the presumption that they’ll be restored as soon as the Treasury spends.

The point is that there are different ways to “skin the cat” that are consistent with the legal mandates. Over the years, the actual operating procedures adopted have changed substantially as the Fed is substantially “independent” to choose the exact procedures adopted. Further, the general requirements or prohibitions mandated in the Federal Reserve Act can be changed by Congress. For example, Congress could allow the Treasury to sell bonds to the Fed—which would simplify procedures. But the end result is essentially the same, no matter which procedures are adopted: the Treasury spends the budgeted amount (fiscal policy) and the Fed hits its interest rate target (monetary policy).

So long as the central bank targets interest rates, its options are limited no matter which procedures are adopted, in the sense that it must operate to minimize fiscal policy effects on reserves and hence on overnight rates. Conforming to the FRA, the Treasury needs to sell Treasuries to private banks when its deposit account at the Fed is insufficient, but banks need reserves to allow the Treasury to shift its deposits. If the Fed provides those in an open market sale, it will need to reverse that once the Treasury does spend. The result of deficit spending by the Treasury will normally lead to a nearly equivalent increase of bank holdings of bonds when all is said is done. This will be true no matter what operating procedures the Fed adopts and regardless of the prohibitions written into the FRA.

The question is whether all of this complexity really matters.¹⁴⁸ If we had the simplified, consolidated government, a budget deficit would lead the nongovernment sector to directly accumulate net claims on the government. Initially, these would be in the form of currency; but if government offers bonds as an interest-earning alternative, then, given portfolio preferences, at least some (and probably much) of the currency would be exchanged for bonds. If we separate the treasury and central bank and impose operational rules like those in the United States, then deficit spending will lead to the same results. While bonds might be sold first, and deposits transferred from private banks to the Fed before the Treasury spends, at the end of the spending process banks will have issued more deposits and will hold some combination of more bonds and more reserves. Just as in the consolidated example above, bank deposits outstanding at the end of the process equal bank holdings of currency (reserves) plus government bonds; nonbanks hold a combination of currency, demand deposits, and bonds; and the quantity of demand deposits held by households and firms will equal bank holdings of government bonds and currency (reserves)—which equals the government’s deficit spending.

We conclude this section with the finding that the legislated “operational independence” of the central bank is limited in practice because the actual procedures adopted ensure the central bank cooperates with the treasury as it implements fiscal policy.¹⁴⁹ It is true that the central bank can choose to keep the interest rate paid by the treasury on its debt higher, or lower, which impacts overall government spending (since interest is a cost covered by spending).

¹⁴⁸ Again, see the previous chapter for more discussion.

¹⁴⁹ This is consistent with the findings of Tymoigne in the preceding chapter.

D. Political independence

That brings us to the final category, political independence, which is linked to operational independence. The question is whether the (limited) operational independence—the “consolidation” of treasury and central bank—allows the central bank to “just say no” to the treasury. That is, could a resolute Fed prevent the Treasury from spending (up to the budgeted amount authorized by Congress)? That would seem to be the only argument that the critics have against consolidation (since the end result in terms of balance sheets is the same).

Let us go through the steps of the process. On current requirements, if the Treasury does not have sufficient deposits in the private banks (tax and loan accounts) to transfer to cover mandated spending, it must first sell bonds. The question is this: will the banks buy them? The answer is pretty simple. We know that even if the banking system has no excess reserves, the Fed will respond to any pressure on overnight interest rates that might be created by banks trying to buy the bonds. If banks are short desired reserves, the Fed supplies them to keep the rate on target. With an interest rate target the Fed always accommodates. That is the macro-level answer.

At the micro level, special banks—dealers—stand ready to buy bonds. To maintain their relationship with the Treasury, they will not refuse. (In the United States there are 21 primary dealers obligated to bid at US government debt auctions: there is literally no chance that the US Treasury could fail to sell bonds.) The dealers would then try to place the bonds into markets. For a sovereign currency issuer that will make interest payments as they come due, there is no fear of involuntary default. It is conceivable that the Treasury has offered maturities that do not match the market’s desires. In that case, prices need to adjust to place the Treasuries—or the dealers will get stuck with the bonds.

In any case, this mismatch is easily resolved if the Treasury offers only very short maturities. This might not seem obvious unless one realizes that short-maturity Treasuries are operationally equivalent to bank reserves that pay a slightly higher interest. As the Fed (like most central banks) targets the overnight rate, reserves can be obtained at that rate. Assuming the central bank is not running an “operation twist” policy (buying longer maturities to target longer term interest rates), it lets the “market” determine rates on longer maturities. (Do not be misled by use of the term “market,” since banks can and do collude to set interest rates—remember the LIBOR scandal. The point is that central banks normally set the shortest-term interest rates “exogenously” in the policy sense while other rates are determined “endogenously,” although perhaps not competitively.) The Treasury can always issue short-term bonds at a small market-determined markup above the overnight target.

The question is not really “will the banks buy Treasuries,” but “at what price.” Very short-term Treasury debt is a nearly perfect substitute for reserves on which the Fed (now) pays interest. Hence, a slight advantage given to short-term Treasury debt will ensure that (non-dealer) banks will exchange reserves for Treasuries. If the Treasury is obstinate, insisting on selling only long maturities, then portfolio preferences can increase rates—perhaps

beyond what the Treasury wants to pay. The solution, of course, is to offer maturities the market prefers—or to pay rates necessary to induce the market to take what the Treasury prefers to issue. Clearly, this is a very easy “coordination problem” to resolve.

The second step requires that the Treasury move deposits from private banks to the Fed. At the same time, the private bank reserves are debited. The Fed does not and will not prevent this from occurring. If the transfer should leave banks short of reserves, the Fed accommodates, either through a temporary bond purchase or by lending at the discount window. In practice, the Treasury coordinates with the Fed so that the Fed is ready to provide reserves as needed. Again, operating with an overnight target rate requires accommodation of the demand for reserves—it is not a choice if the central bank wants to hit its target.

In the third step, the Treasury writes a check (or tells the Fed to credit the reserves of the recipient’s bank, which credits the recipient’s account). Again, the Fed does not and will not prevent this. Note that this will add to banking system reserves and hence normally create excess reserves in the system.

In the fourth step, the Fed removes the excess reserves through an open market sale (or by winding down discount window loans). Of course, this simply reverses the second step. A central bank that is targeting overnight interest rates cannot (normally) leave excess reserves in the system (unless the target is ZIRP—zero—or the central bank already pays interest rates on reserves). In a ZIRP environment (or where the central bank pays the target rate on reserves), excess reserves can remain in the system, with the result that interest rates fall to the rate paid on reserves.

In conclusion, we see that there is no place in the current operating procedures for the Fed to prevent the Treasury from spending budgeted amounts. Presumably, even if the Treasury tried to spend beyond budgeted amounts—perhaps in an attempt to replicate the experience of the Weimar Republic or Zimbabwe—the Fed would actually be powerless to prevent it (although the Fed could react by raising interest rates, which would actually increase the Treasury’s spending on interest, and hence increase the budget deficit). While the current operating procedures—some guided by the FRA of 1913—are believed to have been created to ensure that a runaway Treasury could not finance spending by “running the printing presses,” there is actually nothing in those procedures to prevent it.

As we examined in earlier chapters, during World War II the Fed agreed to keep interest rates low on Treasuries. It subjugated monetary policy to the war effort—keeping rates low meant that even as the outstanding stock of federal government debt grew quickly, government spending on interest rates did not explode. This is the main argument for central bank independence: do not let the central bank finance budget deficits that must lead inevitably to Zimbabwean hyperinflation. The notion is that if the central bank refused, government would have to go to private markets for finance—and that market discipline would somehow prevent inflationary finance of budget deficits. (Given Wall Street’s propensity to finance private spending and debt that couldn’t possibly be repaid, that focus on government debt finance seems rather misplaced.)

Yet, that is the main fear of deficit worriers: government can get stuck in a debt trap whereby budget deficits increase the outstanding debt on which interest must be paid; as interest payments grow, the deficit itself increases. Even if other spending were not growing fast enough to cause the debt-to-GDP ratio to grow, if interest rates on debt exceed the growth rate of GDP, the debt ratio will generally grow (unless the rest of the budget is in surplus). Fed policy in World War II and through to 1951 ensured that would not happen. The Treasury Accord released the Fed from that commitment, although the Fed's interest rate policy kept the short-term rates very low for another decade. As GDP continued to grow, the federal government debt-to-GDP ratio fell quickly in the postwar period.

What do we learn from that experience? Even with budget deficits of 25 percent of GDP, a central bank can keep interest rates very low across the maturity structure. As a creature of Congress, this policy could be mandated if it again became necessary. Alternatively, the Treasury can restrict its new issues to short-term maturities. In that case, the rate on Treasury bills will closely track the Fed's policy rate. So long as the policy rate is kept below the GDP growth rate, the "debt trap" dynamics can be controlled by congressional budgeting that would rein in noninterest spending or raise tax rates. (To be sure, a Zimbabwe-bound Congress could try to keep debt growing faster than GDP by accelerating the growth of budget allocations, and the Fed would not be able to prevent that, as raising rates higher would just hasten the explosive growth of the debt ratio.) If the Fed insisted on keeping interest rates above GDP growth, it would not only cause government debt ratios to grow but also cause private debt ratios to grow. Sooner or later, the economy would probably crash, causing the Fed to relent.

Bad policy—whether monetary or fiscal—is a possible and painful danger. Fortunately, there is nothing in the post-1913 experience to warrant unduly pessimistic views of the motives of either Congress or the Fed. Even the extremes of the Volcker years—short-term rates driven above 20 percent—were eventually reversed and, one hopes, lessons were learned from the experience. Fortunately, in spite of hyperbole to the contrary, there is nothing approaching a congressional consensus that the US government ought to budget to produce hyperinflation.

If anything, all the budgeting errors are on the other side: insufficient fiscal stimulus in the GFC, partisan fighting over expanding the debt limits, tying compromises to sequestration, and an unhealthy fear of budget deficits. While the Fed has a great deal of independence in setting its interest rate target, it appears unlikely that in a crisis (whether induced by excessively high rates on private debt, or high rates on public debt that create an exploding debt ratio, or a major war that requires cooperation between the Fed and Treasury) the Fed would resolutely pursue dangerous policy. And if it did, Congress could intervene.

Finally, as we have seen in the chapters above, Congress has since 1913 continually refined and restated its overriding instruction to the Fed: policy is to be formulated with a view to supporting the national interest. Congress has also shown its willingness to modify the Federal Reserve Act and to (selectively) tighten its control over the Fed. If a growing

budget deficit became necessary to support domestic demand or due to external events (such as military threats to the USA), it is reasonable to suppose that Congress would yet again expect the Fed to support the Treasury's bond issues. And if the Fed did not, Congress can mandate that it do so.

If all of this is correct, the Fed's independence is limited to its insulation from partisan political pressure, and especially freedom from political interference into its rate-setting deliberations.

III. Conclusion: Central Bank Independence

One of the greatest fears about continuous budget deficits is that they might push up interest rates, raising deficits and debt ratios in a self-reinforcing spiral. This is based on the ISLM model, where—except in a liquidity trap with a horizontal LM curve—rising government spending raises interest rates. The result is similar to the loanable funds model, in which it is the government's demand for loanable funds to finance a deficit that causes rates to rise. This belief in deficits pressuring interest rates is nearly universal even though it is wrong. Indeed, unless compensating operations are undertaken, budget deficits push rates down, since they lead to reserve credits in the banking system.

However, the operational function of selling Treasuries is to offer a higher-interest-earning alternative to low-earning reserves (recall that until the GFC reserves paid zero; now they pay a positive rate chosen by the Fed). How much higher? That depends on the maturity of the debt issued and the state of liquidity preference. As Keynes's "square" rule implies, when we adopt ZIRP, the Treasury will generally have to pay about 200 basis points to get banks or others to give up liquidity to hold longer maturities (otherwise potential capital losses when rates rise swamp the yield paid). When short-term rates are higher and are expected to fall, the premium required on long-term maturities is lower (we can even invert the yield-curve structure, with short rates above long rates).

Most "Keynesians" are not worried now about this, believing the United States is in a liquidity trap—as Paul Krugman continually argues. In current conditions, neither deficit spending nor QE is expected to drive up interest rates or inflation. However, many argue that if the government continues to run sustained budget deficits even after recovery, it could get into a debt trap. Trying to finance those deficits supposedly pushes up interest rates paid by government, which increases debt service costs, which accelerates the growth of budget deficits and raises interest rates more. This creates a vicious cycle that increases the debt-to-GDP ratio. Eventually, the bond vigilantes foreclose on the US government, which is forced to grovel like the Greek government before the IMF and the ECB.

But that argument misses the point. Short-term rates are determined by monetary policy—as discussed in the previous chapter. The Fed can pay what it wants on reserves and charge what it wants on lending at the discount window. It targets the fed funds rate and keeps it within the bounds more or less set by the other two rates. When the economy begins to expand, the Fed will most likely raise rates. (And while it might raise rates in response to

budget deficits that is clearly a policy decision, not something that markets do to a sovereign nation.)

Deficits increase bank reserves and sustained deficits will result in excess reserve positions unless countervailing action is taken. Excess reserves put downward pressure on the fed funds rate. The Fed can sell government bonds (open market sale) to relieve that pressure, or the Treasury can sell new bonds. In either case, the operational impact is to substitute Treasuries for excess reserves (it is the opposite of QE). And note that if no such action is taken, budget deficits push interest rates down, not up.

What interest rate will Treasury need to pay to sell those Treasuries? It depends on the maturity of the issues and the state of liquidity preference at the time. The Treasury could choose to sell short-term obligations (bills) at a rate that tracks the Fed's target rate; or it could sell longer maturities. This is part of Treasury "debt management." But note that it is a policy choice, not a bond-vigilante choice. Markets cannot force the Treasury to sell long maturities.

Could the Fed try to make the United States grovel like Greeks have had to do in the EMU crisis? Yes, it could implement a Volcker-style shock, pushing rates above 20 percent, which could get the US government into a vicious interest rate-growing debt cycle. It would, of course, do the same to the private sector—whose debt ratio is already higher than that of the federal government. As the currency issuer, the federal government can probably hold out a lot longer than the private sector. It is not likely that the Fed would be able to pursue such policy long enough to put the sovereign government into a Weimar deficit situation, because it would kill the private sector first by causing massive insolvency and then cascading defaults. That is what Volcker did in the early 1980s. Note that in that episode the private sector crashed and was eventually pulled out of recession by rising Reagan budget deficits. Volcker vigilantism did not cause the Reagan government to retrench; rather, it cut taxes and increased military spending—increasing deficits and bond issues.

The problem is that most people think Fed independence is natural, desirable, immutable. But in reality, the Fed is a branch of government and a creature of Congress. So the question comes down to this: can the Fed go vigilante without Congress putting it back into its proper place? Those who adopt the alternative perspective believe that such a fear represents poor understanding of political economy, and of the Fed's mandate as defined by Congress.

Let us conclude with a quick summary of the MMT alternative perspective on Fed "independence."¹⁵⁰

¹⁵⁰ This alternative view is based on chartalism or the state money approach; it is now associated with Modern Money Theory. See L. Randall Wray, *Modern Money Theory: A Primer on Macroeconomics for Sovereign Monetary Systems* (New York: Palgrave Macmillan, 2012).

Modern money is a state money: the state chooses the money of account, imposes taxes in that unit, and accepts payment in that unit. The state usually issues its own IOUs denominated in the same unit, and accepts its own IOUs in payment. Other entities typically also issue IOUs denominated in the state's money of account; issuers must accept their own IOUs in redemption. There is a hierarchy of monetary IOUs, with the state's currency (including central bank reserves) at the top and used for clearing among financial institutions. State and bank IOUs must be issued first, before they can be returned to their issuers in payment (redemption). Logically, the state must issue its currency through its spending or through lending before it can receive its currency in payment. The same is true of banks taken as a whole: they must lend their notes or deposits into existence before their creditors (note holders or depositors) can make payments to the banks. Unlike banks, however, the sovereign can ensure demand for its currency by imposing obligatory payments—such as taxes—that have to be paid in the sovereign's currency.

All of this was more transparent when sovereigns spent by “raising a tally” or by minting new coin to finance a war. It became a bit more obscure when they would offer exchequer bills for discounting by private banks, obtaining notes they would spend and collect in taxes. And after one bank was given monopoly power to become the state's own bank—a central bank—matters apparently became opaque to many observers. The state no longer spent its IOUs, but rather ran its fiscal operations through its central bank, issuing bills, receiving credits to its account, spending central bank IOUs, and receiving the same in tax payments. The private banks were brought into a triangle, with treasury spending leading to credits to private bank deposits, and taxes paid out of private bank accounts—with the central bank then intermediating between the private banks and the treasury to facilitate these fiscal operations.

This obscured sovereign finances, making it easier to suppose that the sovereign currency issuer operates like a household, receiving income (taxes), spending out of its receipts, and “borrowing” if it was short. In the alternative view, that is precisely wrong. A sovereign currency issuer is nothing like a household user of the currency. Indeed, our understanding of sovereign finance is better informed by returning to the tally sticks or coins that sovereigns “spent” into circulation and then collected in taxes. Modern operational procedures obscure but do not substantially modify the logic.

Before concluding, let us return to the issue of central bank independence. There are a number of indices that claim to rank central banks according to degree of independence, and some studies link that to inflation. These typically rank the US Fed (and the Bundesbank before unification, or the ECB after unification) as relatively independent. Even if we dismiss the claim that bond market vigilantes can push up sovereign interest rates by arguing that the central bank can control rates, there is the possibility that, say, the Fed would refuse to relieve pressure on the federal government's finances. However, the claims for Fed independence are overstated. First, for the reasons discussed above, the Fed must coordinate with Treasury operations to ensure it can hit overnight rate targets. Second, the Fed is a “creature of Congress,” created by public law that has been amended several times. This is recognized by the Fed itself. As already discussed above, the Fed's MacLaury put it this way:

The Federal Reserve System is more appropriately thought of as being “insulated” from, rather than independent of, political—government and banking—special interest pressures.

In effect, the [1951] accord established that the central bank would act independently and exercise its own judgment as to the most appropriate monetary policy. But it would also work closely with the Treasury and would be fully informed of and sympathetic to the Treasury's needs in managing and financing the public debt. In fact, in special circumstances the Federal Reserve would support financing if unusual conditions in the market caused an issue to be poorly accepted by private investors.¹⁵¹

Our understanding of policy, of the policy space available to the sovereign, and of the operational realities of fiscal and monetary policy would be improved if we abandoned the myth of central bank independence.

¹⁵¹ See Bruce K. MacLaury; “Perspectives on Federal Reserve Independence—A Changing Structure for Changing Times,” The Federal Reserve Bank of Minneapolis, *1976 Annual Report*, January 1, 1977, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=690.

CHAPTER 6. Conclusions

I. Overview of the Project

In its response to the expanding financial crisis touched off in the spring of 2007, the Federal Reserve engaged in actions well beyond its traditional lender-of-last-resort support to insured deposit-taking institutions that were members of the Federal Reserve System. Support was eventually extended to noninsured investment banks, broker-dealers, insurance companies, and automobile and other nonfinancial corporations. By the end of this process, the Fed owned a wide range of real and financial assets, both in the United States and abroad. While most of this support was lending against collateral, the Fed also provided unsecured dollar support to foreign central banks directly through swaps facilities that indirectly provided dollar funding to foreign banks and businesses.

This was not the first time such generalized support had been provided to the economic system in the face of financial crisis. In the crisis that emerged after the German declaration of war in 1914, even before the Fed was formally in operation, the Aldrich–Vreeland Emergency Currency Act provided for the advance of currency to banks against financial and commercial assets. The Act, which was to cease in 1913 but was extended in the original Federal Reserve Act, expired on June 30, 1915. As a result, similar support to the general system was provided in the Great Depression by the “emergency banking act” of 1933 and eventually became section 13c of the Reserve Act.

Whenever the Federal Reserve acts in this way to provide support to the stability of the financial system, it also intervenes in support of individual institutions, both financial and nonfinancial. It thus usurps the normal action of the private market process, while at the same time it is not subject to the normal governance and oversight processes that characterize government intervention in the economy. There is no transparency, no discussion, and no congressional oversight.

The very creation of a central bank in the United States, which had been considered a priority ever since the 1907 crisis, generated a contentious debate over whether the bank should be managed and controlled by the financial system that it was supposed to serve, or whether it should be the subject to implementation of government policy and thus under congressional oversight and control. This conflict was eventually resolved by creating a system of Reserve Banks under control of the banks it served, and a Board of Governors in Washington under control of the federal government.

As we have demonstrated in earlier chapters, the role of the Fed and questions of governance and independence of the Fed have always been contentious issues. Views on these issues have evolved considerably over time. A century after its founding, the Fed remains a “work in progress.”

In the recent crisis, the decisions that resulted in direct investments in both financial and nonfinancial companies were taken by the Fed, largely without congressional oversight.

Criticism of these actions referred to the fact that many of the decisions should have been taken by the Treasury and subject to government decision and oversight. For example, critics point out that the assets acquired by the Fed in the Bear Stearns bailout are held in an investment fund owned by the Fed but managed by a private sector financial institution, the Blackstone Group. In the Great Depression, such intervention with respect to the rescue of failed banks was carried out through a federal government agency, the Reconstruction Finance Corporation. Insolvent institutions were taken over, not bailed out; management was replaced, and when the institution could not be restored to good health, it was resolved. This time around, the Fed (with help from the Treasury) avoided resolution and instead either propped up (seemingly) insolvent institutions through continuous lending at low rates, or through “deal making” that folded troubled institutions into other institutions.

In a sense, any action by the Fed—for example, when it sets interest rates—usurps the market process without providing any other form of governance. This is one of the reasons that the Fed stopped intervening in the long-term money market, since it was thought that this would have an impact on investment allocation decisions thought to be determined by long-term interest rates. In the current crisis, the Fed has once again taken up intervention in longer-term securities markets in the form of the policy of quantitative easing.

As a result of these extensive interventions in financial markets and the Fed’s supplanting of normal economic processes, both Congress and the public at large have become increasingly concerned not only about the size of the financial commitments that have been assumed by the Fed on their behalf, but also about the lack of transparency and normal governmental oversight surrounding these actions. For the most part, the Fed refused requests for greater access to information. This is indeed ironic, for the initial request for rescue funds by Treasury Secretary Paulson was rejected precisely because it lacked details and a mechanism to give Congress oversight on the spending. Eventually, a detailed stimulus package that totaled nearly \$800 billion gained congressional approval. But the Fed spent, lent, or promised far more money than Congress has so far approved for direct government intervention in response to the crisis.

Most of these actions were negotiated in secret, often at the New York Fed with the participation of Treasury officials. The justification is that such secrecy is needed to prevent increasing uncertainty over the stability of financial institutions and generating uncertainty that could lead to a collapse of troubled institutions, which would only increase the government’s costs of resolution. There is, of course, a legitimate reason to fear sparking a panic.

Yet, even when relative calm returned to financial markets, the Fed continued to resist requests to explain its actions even *ex post*. This finally led Congress to call for an audit of the Fed in a nearly unanimous vote. Some in Congress continue to question the legitimacy of the Fed’s independence. In particular, given the importance of the New York Fed, some are worried that it is too close to the Wall Street banks it is supposed to oversee and that it has in many cases been forced to rescue. The president of the New York Fed met frequently with top management of Wall Street institutions throughout the crisis, and reportedly pushed deals that favored one institution over another. However, like the other presidents

of district banks, the president of the New York Fed is selected by the regulated banks. This led critics to call for a change to allow appointment by the president of the nation. Critics note that while the Fed has become much more open since the early 1990s, the crisis has highlighted how little oversight the congressional and executive branches have over the Fed, and how little transparency there is even today.

There is an inherent conflict between the need for transparency and oversight when public spending is involved and the need for independence and secrecy in formulating monetary policy and in supervising regulated financial institutions. A democratic government cannot formulate its budget in secrecy. Except when it comes to national defense, budgetary policy must be openly debated and all spending must be subject to open audits. That is exactly what was done in the case of the stimulus package.

However, it is argued that monetary policy cannot be formulated in the open—a long and drawn-out open debate by the Federal Open Market Committee about when and by how much interest rates ought to be raised would generate chaos in financial markets. Similarly, an open discussion by regulators about which financial institutions might be insolvent would guarantee a run out of their liabilities and force a government takeover. Even if these arguments are overstated and even if a bit more transparency could be allowed in such deliberations by the Fed, it is clear that the normal operations of a central bank will involve more deliberation behind closed doors than is expected of the budgetary process for government spending. Further, even if the governance of the Fed were to be substantially reformed to allow for presidential appointments of all top officials, this would not reduce the need for closed deliberations.

The question is whether the Fed should be able to commit the Congress and citizens in times of national crisis. Was it appropriate for the Fed to commit the US government to trillions of dollars of funds to bail out US financial institutions, as well as foreign institutions and governments? When Chairman Bernanke testified before Congress about whether he had committed the “taxpayers’ money,” he responded “No,” the Fed is simply entries on balance sheets. While this response is operationally correct, it is also misleading. There is no difference between a Treasury guarantee of a private liability and a Fed guarantee. When the Fed buys an asset by means of “crediting” the recipient’s balance sheet, this is not significantly different from the US Treasury financing the purchase of an asset by “crediting” the recipient’s balance sheet. The only difference is that in the former case the debit is on the Fed’s balance sheet and in the latter it is on the Treasury’s balance sheet. But the impact is the same in either case: it represents the creation of dollars of government liabilities in support of a private sector entity.

The fact that the Fed does keep a separate balance sheet should not mask the identical nature of the operation. It is true that the Fed normally runs a profit on its activities since its assets earn more than it pays on its liabilities, while the Treasury does not usually aim to make a profit on its spending. Yet Fed profits above 6 percent are turned over to the Treasury. If its actions in support of the financial system reduce the Fed’s profitability, Treasury revenues will suffer. If the Fed were to accumulate massive losses, the Treasury would have to bail it out—with Congress budgeting for the losses. It is not likely that this

will be the case, but the point remains that in practice the Fed's obligations and commitments are ultimately the same as the Treasury's, and these promises are made without congressional approval, or even its knowledge many months after the fact.

Some will object that there is a fundamental difference between spending by the Fed and spending by the Treasury. The Fed's actions are limited to purchasing financial assets, lending against collateral, and guaranteeing private liabilities. While the Treasury also operates some lending programs and guarantees private liabilities (for example, through the FDIC and Sallie Mae programs), and while it has purchased private equities in recent bailouts (of GM, for example), most of its spending takes the form of transfer payments and purchases of real output. Yet, when the Treasury engages in lending or guarantees, its funds must be provided by Congress. The Fed does not face such a budgetary constraint—it can commit to trillions of dollars of obligations without going to Congress.

Further, when the Treasury provides a transfer payment to a Social Security recipient, a credit to the recipient's bank account will be made (and the bank's reserves credited by the same amount). If the Fed were to buy a private financial asset from that same retiree (let us say it is a mortgage backed security), the bank account would be credited in exactly the same manner (and the bank's reserves would also be credited). In the first case, Congress has approved the payment to the Social Security beneficiary; in the second case, no congressional approval was obtained.

While these two operations are likely to lead to very different outcomes (the Social Security recipient is likely to spend the receipt; the sale of a mortgage-backed security simply increases the seller's liquidity and may not induce spending by the seller), so far as creating a government commitment they are equivalent, because each leads to the creation of a bank deposit as well as bank reserves.

Again, this equivalence is masked by the way the Fed's and the Treasury's balance sheets are constructed. Spending by the Treasury that is not offset by tax revenue will lead to a reported budget deficit and (normally) to an increase in the outstanding government debt stock. By contrast, spending by the Fed leads to an increase of outstanding bank reserves (an IOU of the Fed) that is not counted as part of deficit spending or as government debt and is off the government balance sheet. While this could be seen as an advantage because it effectively keeps the support of the financial system in crisis "off balance sheet," it comes at the cost of reduced accountability and diminished democratic deliberation. This is unfortunate because operationally there is no difference between support for a financial or nonfinancial entity taken by the Treasury "on the balance sheet" and one that is undertaken by the Fed "off the balance sheet" and thus largely unaccountable.

There is a recognition that financial crisis support necessarily results in winners and losers, and socialization of losses. At the end of the 1980s, when it became necessary to rescue and restructure the thrift industry, Congress created an authority and budgeted funds for the resolution. It was recognized that losses would be socialized—with a final accounting in the neighborhood of \$200 billion. Government officials involved in the resolution were held accountable for their actions, and more than one thousand top management officers of

thrifts went to prison. While undoubtedly imperfect, the resolution was properly funded, implemented, and managed to completion. In general outline, it followed the procedures adopted to deal with bank resolutions in the 1930s.

By contrast, the bailouts in the much more serious recent crisis have been uncoordinated, mostly off budget, and done largely in secret—and mostly by the Fed. There were exceptions, of course. There was a spirited public debate about whether government ought to rescue the auto industry. In the end, funds were budgeted and government took an equity share and an active role in decision making, openly picking winners and losers. Again, the rescue was imperfect, but today it seems to have been successful. Whether it will still look successful a decade from now we cannot know, but at least we do know that Congress decided the industry was worth saving as a matter of public policy.

No such public debate occurred in the case of the rescue of Bear Stearns, the bankruptcy of Lehman brothers, the rescue of AIG, or the support for Goldman Sachs.

This project will continue to explore these issues. In our final report, to be issued in April 2015, we will finish our assessment of the Fed's policy response, compare that to successful policy responses in the past and across the globe, and formulate a "best practices" proposal to serve as the basis for a response to the next serious financial crisis.