The Evolution of Fed Independence

BY STEPHEN SLIVINSKI

How monetary policy and central bank autonomy came of age

Today there is a consensus that a central bank can best contribute to good economic performance by pursuing price stability — and that it should remain independent from political forces. In the case of price stability, this understanding evolved over decades of experience. The notion of independence of the central bank was more difficult to fulfill.

The original conception of the Federal Reserve System when it was created in 1913 was meant to continue the spirit of the "independent treasury system" that existed in the pre-Fed era. That system assumed that the U.S. Treasury would store its gold and assets in its own vaults lest it unduly influence the markets for credit and money. Ideally, Treasury meddling in what passed for monetary policy at the time was to be avoided.

Yet for most of the first four decades of its existence, a lack of independence was characteristic of the Federal Reserve. The hand of the executive branch of the U.S. government was ever-present when the Fed began operations in November 1914. The 1913 act that created the Fed made the Secretary of the Treasury and the Comptroller of the Currency *ex officio* members of the Board. In fact, the Treasury secretary presided over all meetings in those early days. The Board did not have its own building — they held their meetings in the Treasury building instead.

Thus, the evolution of monetary policy cannot be understood without an understanding of the changes and personalities involved in the evolution of the Fed as an institution. Throughout much of its history, the struggle for independence has often occurred in conjunction with changes in policy — and these changes have tended to reinforce each other.

Wars, Depression, and Dependence

When the United States entered World War I in April 1917, the Federal Reserve almost instantly became the primary vehicle for financing the war effort. The main function of the Fed during those war years was to lend money to banks to purchase "Liberty Loans" bonds from the U.S. Treasury. They loaned the money at a discounted rate — not coincidentally lower than the interest rate on the war bonds — to entice bond purchasers. After the war, the Federal Reserve Bank of New York remained the official fiscal agent of the U.S. Treasury Department.

In the post-war years, the Fed busied itself with maintaining the newly reconstructed gold standard. Its missteps in the wake of the stock market of October 1929 contributed to the impression that the Fed was powerless.

Political forces retained the upper hand in the economic upheaval of the Great Depression. As economist Allan Meltzer points out in his history of the Fed, monetary policy would basically be dictated by Congress and the White House between 1933 and 1951. For instance, after Franklin Roosevelt became president in 1933 he assumed emergency powers that explicitly took the United States off the gold standard. Congress would later that year mandate that the Fed issue "reserve notes" not backed by gold. The Fed was forced to freeze its asset portfolio and the monetary base was effectively determined by the Treasury.

Additionally, the Federal Reserve structure as we know it today is a byproduct of the policy actions taken during the Great Depression. Many of

Although the Fed Board of Governors moved into their own building in 1937, their independence in monetary policy wasn't established until 1951. The headquarters was named the Eccles Building — after the former Fed chairman influential in achieving Fed independence — in 1982.

PHOTOGRAPHY: FEDERAL RESERVE BOARD OF GOVERNORS them were motivated by a desire of policymakers to further centralize control over monetary policy. When Roosevelt went looking for a new head of the Federal Reserve Board, he settled on Marriner Eccles, an assistant to his Treasury secretary. Yet Eccles told the president he wouldn't take the job unless the Fed was reformed to give the Board more power over the regional Fed banks. The 1935 amendment to the Federal Reserve Act modified the FOMC and Eccles became its chief. He would serve as chairman until 1948.

While the 1935 act took the Secretary of the Treasury and the Comptroller of the Currency off the Fed Board, it didn't translate into a softer hand by the executive branch in monetary policymaking. When the United States entered World War II, the Fed became again a mechanism by which the government could more cheaply finance the war effort. In April 1942, the Fed announced a policy of cooperating with the Treasury to keep interest rates low. By 1947, the Fed was summarizing its "primary duty" as "the financing of military requirements and of production for war purposes." In his memoirs, Eccles even described his work during this period as "a routine administrative job" as the Fed "merely executed Treasury decisions." Alan Sproul, the president of the New York Fed, lamented, "We are not the masters in our own house."

The Accord

After the war, Eccles — worried about inflation — began to make strong statements behind the scenes to the effect that the Fed should no longer support the prices of Treasury bonds. The "peg," as it was called, was the rule by which the Fed would buy up those Treasury securities if prices fell as a result of a sell-off. President Truman didn't take kindly to the Fed's new stirrings of independence and told Eccles that he would not be reappointed when his term as chairman was over in 1948. He was replaced by Thomas McCabe but stayed on the Board as vice chairman.

Yet many within the Fed, particularly New York's Sproul, were worried about the loss of Fed independence. For the next two years, the Fed and the Treasury would cooperate but in a rather tense and uneasy way. While the Treasury bond peg remained mostly intact, the stage was slowly being set for a showdown.

The spark that ignited the next consequential chain of events was the Korean War which began on June 26, 1950. Although the first year of that war was financed mainly by tax increases, the Treasury Secretary John Snyder made no secret of his department's commitment to keeping the Fed in the business of maintaining the bond price peg.

The FOMC had other ideas in mind. Still wary of inflation, Fed policymakers were eager to raise the short-term interest rate to reduce the money supply and stave off price increases. That would also have an effect on government financing of debt — it would drive down the price of bonds, which is always inversely correlated with the interest rate, and also increase the government's cost of borrowing.

After the August 1950 FOMC meeting, a movement was afoot to persuade Snyder to accept a small increase in short-term interest rates. At that meeting, Sproul raised a challenge: The FOMC "should not seek instructions" from the U.S. Treasury. Eccles agreed and said that if the Fed is "expected to survive as an agency with any independence whatsoever [it] should exercise some independence."

President Truman was also willing to try to influence Fed policy. In early December 1950, he phoned McCabe at his home and urged him to "stick rigidly" to the pegged bond rates. "I hope the Board will not allow the bottom to drop from under our securities. If that happens that is exactly what Mr. Stalin wants."

To help smooth relations and try to persuade the administration to change their stance on the bond peg, McCabe met with Truman and Snyder at the White House on Jan. 17, 1951. The chairman stated the concerns of the Fed and the meeting ended without a specific resolution. McCabe seemed convinced that their conversation would continue behind the scenes at a later date.

But the next day Snyder delivered a speech to the New York Board of Trade in which he announced that McCabe had agreed with the Treasury's peg policy. This infuriated the members of the FOMC. The minutes of the Fed meeting record that McCabe reported to his colleagues that he had made no such commitment.

The Fed decided to fight back. At their January 29 meeting, in a challenge to the Treasury, the Fed allowed the price of the pegged government bond to drop. The action prompted Truman to call the entire FOMC to the White House to apply some pressure the next day. It was the first time a U.S. president had done such a thing.

As Meltzer describes it, "The meeting with the president smothered the conflict in ambiguity. Everyone seemed to agree, but no one changed position." Yet the FOMC members also were confident that nothing said at the meeting could have been construed as an endorsement of the Treasury's policy position.

At noon on February 1, the White House released a press statement that took the Fed policymakers by surprise: The Truman administration announced that the Federal Reserve Board had agreed to the peg policy. In his memoirs, Eccles noted that if swift action was not taken , the Federal Reserve would lose the independent status Congress meant it to have and "would be reduced to the level of a Treasury bureau."

The fight for Fed independence also began to hone the thinking of Fed policymakers about the nature of inflation and the consequences of pegging the interest rate of Treasury bonds. By committing to a policy of buying those bonds when the price fell below an arbitrary level, the FOMC members began to understand that they were expanding the money supply. Richmond Fed economist Robert Hetzel and former Board of Governors economist Ralph Leach suggests this marked an "intellectual watershed." "Gone," they write, "was the self-image of a central bank that allows an 'elastic currency' passively to 'accommodate commerce.' The Fed moved toward the idea of control of money creation to stabilize the purchasing power of the dollar."

The Fed forced resolution of the dispute on February 19. That day it informed the Treasury that it "was no longer willing to maintain the existing situation in the Government security market." As Sproul recounted in congressional testimony a year later, the Fed also let them know that unless there was someone at the Treasury who could work out a prompt and definitive agreement with them, they "would have to take unilateral action."

The Treasury finally acknowledged the need to end the public dispute by holding a meeting at the White House between the president and other government policymakers. Snyder, however, was not at the meeting. He was in the hospital recovering from surgery. Instead, he left the negotiations in the hands of William McChesney Martin, assistant secretary of the Treasury.

After a few days of negotiation, the parties involved agreed on what became known as the Treasury-Fed Accord. As ratified, it read: "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."

This newfound independence by the central bank would mark the start of a new era for the Fed. "For the first time since 1934, the Federal Reserve could look forward to conducting monetary actions without approval of the Treasury," writes Meltzer. Now the Fed "faced the task of rediscovering how to operate successfully."

That task would have to be undertaken with a new leader. In one final shot at the Fed, Truman told McCabe that his "services were no longer satisfactory." Even though his term ran until 1956, McCabe agreed to resign — but only under the condition that he be replaced with someone who would pass muster with the FOMC. The president appointed William McChesney Martin, one of the key figures in the Treasury-Fed Accord negotiations. He would go on to serve for almost 19 years once he assumed office on April 2, 1951 — the longest term of any chairman to this day.

A Brief Detour

The Martin era is still seen today as a vital period during which the Fed was established as a credible and autonomous policymaking body. Part of the success of the Martin years was the unwillingness of President Dwight Eisenhower to meddle in Fed policy the way his predecessors had.

On the other hand, throughout his presidency Lyndon Johnson was eager to get Martin to pursue an easy money policy to assist him in funding both the Vietnam War and his deficit-fueled increases in government spending. Johnson frequently criticized Martin's policies in private meetings and asserted that he seemed intent on hurting Johnson politically.

LBJ's crusade to steer Martin was ultimately an ineffective one. Yet Johnson did reappoint Martin in 1966 for what would become his last term as Fed chairman.

Another president for whom Fed policy was seen as a tool to influence political outcomes was Richard Nixon. In his memoirs he was quite outspoken about how he thought the tight Federal Reserve monetary policy virtually killed his chances of getting elected president in 1960.

In 1970, President Richard Nixon was intently pursuing a political strategy that had as one of its goals increased employment through easy money. He appointed Arthur Burns as Fed chairman with the expectation — sometimes explicitly stated — that he would be more sympathetic to using monetary policy to pull unemployment down. During an applause-filled interlude at Burns' swearing-in ceremony, Nixon famously turned to him and said: "You see, Dr. Burns, that is a standing vote of appreciation in advance for lower interest rates and more money."

Burns was initially sympathetic, and that mutual expectation married a shift in monetary policy with a close relationship between the White House and the Fed that didn't exist since the pre-Martin days. Burns, like Nixon, had a view of inflation that made him prone to believing that hard-money Fed policies would be misguided in the 1970s. He came to believe the "cost-push" model of price increases in which inflexible labor union contracts were keeping wages artificially high and contributing to inflation in the price of goods that utilized that labor. In that model, monetary policy was ineffective at battling inflation in the short term.

The temporary weakening of Fed independence under Burns wasn't motivated only by the president's steps toward assuring a compliant Fed. They were also facilitated by Burns himself who was quite willing to bargain with the White House to achieve policy outcomes that he saw as critical to defeating cost-push inflation. Economic historians acknowledge that he at least tacitly promised an easy money policy to the White House in exchange for Nixon's imposition of wage and price controls.

The consensus of the economics profession since then is that such controls and the easy money policy that accompanied them were harmful to the economy. The high inflation it created led to a period of economic stagnation that lasted until the early 1980s.

What broke the cycle was the appointment of Paul Volcker as chairman in 1979. Volcker was able to restore not only a more Martin-esque monetary policy by taming inflation and slowing money growth but also restore the independence and credibility of the Fed. Political support in such an endeavor was also important, and the lack of meddling by both presidents Jimmy Carter and Ronald Reagan was crucial to that success.

A New Accord?

Just as policy shifts in the past have been tied to shifts in Fed independence, a new concern among some economists is

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ing of slave property over other forms of property in the antebellum days.

In April 1862, voters of the then-fledgling state approved the new constitution, and in May the new "Restored Government of Virginia" petitioned the U.S. Congress for recognition of the state. As Congress deliberated, the Union was effective at holding the line in West Virginia despite a few attempts by the Confederate army to capture territory. Indeed, when the de facto legislature of West Virginia sent to the Virginia General Assembly a request to secede in May, it was granted. When Congress finally granted approval in December and President Lincoln concurred, the only step to be taken was a referendum terminating slavery in their territory, which passed handily.

The state of West Virginia was accepted into the Union on June 20, 1863. It has the distinction of being one of only two states formed during the Civil War (the second was Nevada). Additionally, it was the only state to form by seceding from a Confederate state (though similar proposals were debated in other states, including North Carolina and Tennessee).

Yet, while many of the debates about secessions are largely looked upon as epic battles over abolition, West Virginia's secession was mainly the result of economic concerns. As Rasmussen notes, those most eager to secede from the Old Dominion were acting on "an extremely rational expression of enlightened self-interest." In retrospect, it's no mystery why the western counties sought to leave Virginia. Perhaps a more difficult question is why the marriage persisted as long as it did. **RF**

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whether current Fed actions may jeopardize Fed independence in the future. This recession has spurred new expansions in the Fed's loan portfolio, opening up its lending window to institutions that were not privy to Fed funds before the economic downturn. Indeed, some have argued that this has been a long-standing shift in Fed credit policy that started with lending meant to prop up the Penn Central Railroad in 1970, the infusion of liquidity the Fed provided to the failing Continental Illinois National Bank in 1984, and the engineered bailout of Long-Term Capital Management in 1998.

Consequently, economist Marvin Goodfriend, formerly of the Richmond Fed and currently of Carnegie Mellon University, has proposed a "new accord" for Fed credit policy. Meant to mimic what the Treasury-Fed Accord did for monetary policy, the goal would be to place explicit boundaries on actions that could harm Fed independence.

"It's important to appreciate the difficulties to which the Fed exposes itself in the pursuit of credit policy initiatives that go beyond traditional last resort lending to banks," notes Goodfriend. Not only does it open the door for more congressional pressure to lend to some and not to others, but it also puts the Fed in an untenable position when the Fed must cooperate with the Treasury on items such as banking regulation and payments system policy. "This interdependence exposes the Fed to political pressure to make undesirable concessions with respect to its credit policy initiatives in return for support on other matters."

Only time will tell whether the recent expansion in Fed lending will be temporary or not. In the meantime, it's important to understand the historical experience of the Fed. The independence of the Fed is something that Fed policymakers still tend to guard closely. Yet it's not always the case that independence is taken away all at once as it has been in previous decades, particularly during wartime. Some Fed observers and policymakers worry that actions that may seem well-intentioned and short-lived today could chip away at Fed autonomy over the long term. **RF**

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