

**We Need an “Accord” for Federal Reserve Credit Policy**

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The 1951 “Accord” between the United States Treasury and the Federal Reserve was one of the most dramatic events in U.S. financial history. The Accord ended an arrangement dating from World War II in which the Federal Reserve agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Truman Treasury urged that the agreement be extended to keep interest rates low in order to hold down the cost of the huge Federal government debt accumulated during the war. Federal Reserve officials argued that keeping interest rates low would require inflationary money growth and destabilize the economy.

In the face of strong opposition from the Truman administration, and with considerable drama, the Federal Reserve prevailed by working hard to create an understanding of its position in the country at large.<sup>2</sup> The concern about inflation became acute with the outbreak of the Korean War in June 1950, especially after the Chinese entered the conflict late in 1950.

Under pressure from the public, the press, and Congress, the Truman Treasury reluctantly agreed in early 1951 to free the Federal Reserve from the commitment to keep interest rates low. The so-called “Accord” between the Treasury and the Federal Reserve was only one paragraph, but it famously

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<sup>2</sup> H. Stein “The Liberation of Monetary Policy,” in *the Fiscal Revolution in America*, pp. 241-80. Chicago: University of Chicago Press, 1969.

reasserted the principle of Federal Reserve independence so that monetary policy might serve primarily as an instrument to stabilize inflation and macroeconomic activity.

The Federal Reserve has long executed credit policy in addition to monetary policy, usually as “lender of last resort” to the banking system. Credit policy is also subject to misuse for fiscal policy purposes. However, as long as Fed lending was relatively modest and confined to the banking system, and the Fed took good collateral against its loans, the potential for fiscal misuse was relatively limited, at least by today’s standards.<sup>3</sup>

So, although the Fed has long needed an “Accord” for its credit policy, a credit accord did not seem to be a pressing matter.<sup>4</sup> Today, however, the Fed has on its balance sheet over 1 *trillion* dollars of credits---loans to banks and to other financial institutions, and loans to special purpose entities to finance the purchase of commercial paper and other asset-backed securities. Prior to this, the most expansive, prolonged Fed lending was a loan of roughly 5 *billion* dollars to Continental Illinois Bank from May 1984 until February 1985.<sup>5</sup>

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<sup>3</sup> A. Schwartz, “The Misuse of the Fed’s Discount Window,” Federal Reserve Bank of St. Louis *Economic Review* (September/October 1992), 58-69.

<sup>4</sup> M. Goodfriend, “Why We Need an “Accord” for Federal Reserve Credit Policy,” *Journal of Money, Credit, and Banking* (August 1994), pp. 572-80.

<sup>5</sup> For a brief period following 9/11, Fed lending to banks rose above 30 billion dollars. Fed credit volumes mentioned in the text are overnight loans.

The enormous expansion in Fed lending today—in scale, in reach beyond banks, and in acceptable collateral—demands an accord for Fed credit policy to supplement the accord on monetary policy. A credit accord should set guidelines for Fed credit policy so that pressure to misuse Fed credit policy for fiscal purposes does not undermine the Fed’s independence and impair the central bank’s power to stabilize financial markets, inflation, and macroeconomic activity.

After drawing the key distinction between monetary and credit policy, illustrated with recent policy actions, the present essay identifies fiscal aspects of credit policy that have the potential to create conflict with the fiscal authorities—the Treasury and the Congress. Building on the notion that independence is essential to carry out the Fed’s stabilization objectives effectively, and that conflict with the fiscal authorities must be minimized to secure Fed independence, the essay proposes a set of principles to serve as the basis for a Fed credit accord.

As proposed below, an accord will be seen to be in the interest of both the Fed and the Treasury and very much needed in the current crisis. In fact, the joint statement issued on March 23, 2009 by the Department of the Treasury and the Federal Reserve “The Role of the Federal Reserve in Preserving Financial and Monetary Stability” indicates that the authorities recognize that overall financial policy is well-served by clarifying the relationship between the Treasury and Fed

in the crisis.<sup>6</sup> The essay to follow supports such clarification and suggests why more needs to be done.

### The Distinction between Monetary Policy and Credit Policy

The distinction between monetary policy and credit policy is straightforward. Monetary policy refers to Federal Reserve policy actions that change the stock of high-powered money, i.e., currency plus bank reserves. The Fed's power to determine the stock of high-powered money has enabled it to manage the federal funds rate and to pursue interest rate policy as directed by the Federal Open Market Committee. In order to cut its federal funds rate target, the Fed adds reserves to the banking system by purchasing securities. At the start of the credit turmoil in the summer of 2007, the Fed had on its balance sheet roughly 850 billion dollars of securities obtained in the course of supplying the economy with currency and bank reserves.

In order to avoid carrying credit risk on its balance sheet, the Fed historically has satisfied the bulk of its asset acquisition needs in support of monetary policy by purchasing outstanding Treasury securities and those securities deemed to have the explicit backing of the Treasury, an asset acquisition policy known as

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<sup>6</sup> Charles I. Plosser, President of the Federal Reserve Bank of Philadelphia, and Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, recently expressed support for clarification of the proper boundaries for Fed credit policy. See Plosser, "Ensuring Sound Monetary Policy in the Aftermath of the Crisis," February 27, 2009, and Lacker, "Government Lending and Monetary Policy," March 2, 2009.

“Treasuries only.” The Fed returns to the Treasury all but a small fraction of the interest on the Treasury securities that it holds; the remainder is utilized to pay its operating expenses. Fed interest payments to the Treasury in 2006 were around \$30 billion. Given the huge volume of Treasury debt outstanding and likely to remain outstanding, the Fed could manage monetary policy indefinitely without abandoning “Treasuries only.”

Things changed in the last couple of years with the Fed’s aggressive use of credit policy to deal with the turmoil in credit markets. The Fed takes a credit policy action as distinct from a monetary policy action by shifting the composition of its assets holding high-powered money fixed. For example, the first large-scale credit policy actions undertaken by the Fed in the current turmoil involved lending to banks through the Term Auction Facility funds acquired by selling Treasury securities from its portfolio with no effect on aggregate bank reserves outstanding or the size of the Fed’s balance sheet. Such “pure” central bank credit policy initiatives simply shifted the composition of the Fed’s balance sheet to bank loans from Treasuries independently of monetary policy. Needless to say, the Fed can always pursue “pure” monetary policy independently of credit policy by following “Treasuries only.”

The Fed has employed both monetary policy and credit policy aggressively since the fall of 2007 to deal with the credit market turmoil. On the monetary

policy side, the Fed expanded the size of its balance sheet by acquiring roughly 1 trillion dollars of new assets with freshly created bank reserves as it brought its federal funds rate target to near zero.

On the credit policy side, the Fed extended over 1 trillion dollars of loans to banks and non-bank financial institutions, and to special purpose entities to finance the acquisition of commercial paper and asset-backed securities. The Fed financed roughly 1 trillion dollars of these credit initiatives with the newly created bank reserves. In other words, the Fed pursued an unprecedented expansion of credit policy in conjunction with the unprecedented expansion of monetary policy—a combination credit and monetary policy—to stabilize financial markets, inflation, and economic activity against the downturn. In addition, the Fed utilized 300 billion dollars of new Treasury deposits to fund an additional 300 billion in credit initiatives. Since the Treasury financed these deposits by issuing debt, this portion of Fed asset acquisition was pure credit policy.

### Fiscal Aspects of Credit Policy

Fed credit initiatives described above utilize *fiscal policy* to improve flows in credit markets. When the Fed substitutes an extension of credit for a Treasury security in its portfolio, the Fed can no longer return to the Treasury the interest it had received on the Treasury security that it held. In other words, when the Fed

sells a Treasury security to make a loan, it's as if the Treasury issued new debt to finance the loan. Credit policy executed by the Fed is really debt financed fiscal policy.

Fed credit policy “works” by exploiting the creditworthiness of the government to acquire funds at a riskless rate of interest in order to make those funds available to financial institutions that otherwise would have to pay a much higher risk premium to borrow, if they can borrow at all under current circumstances. Fed lending exploits another advantage relative to private lenders: in the event of a default, the Fed as a government entity may be able to seize the loan collateral immediately, whereas a private lender may have its collateral tied up in bankruptcy proceedings.

Collateralized Fed credit policy is risky not only because the borrower might default, but also because collateral might prove to be worth less than the loan in the event of a borrower default. In effect, Fed credit policy works by interposing the United States Treasury between lenders and borrowers in order to improve credit flows. In doing so, however, the Fed essentially makes a fiscal policy decision to put taxpayer funds at risk. In the event of a default, if the collateral is unable to be sold at a price sufficient to restore the initial value of Treasury securities on the Fed's balance sheet that was used to fund the credit initiative, then the flow of Fed remittances to the Treasury will be smaller after the loan is unwound. The Treasury



will have to make up that shortfall somehow, namely, by lowering expenditures, raising current taxes, or borrowing more and raising future taxes to finance increased interest on the debt.

### Federal Reserve Independence

The 1951 Accord restored the Fed's *instrument* independence after the wartime interest rate peg. Since then, the Fed has managed aggregate bank reserves and the federal funds rate flexibly to achieve its macroeconomic objectives. Congress early on recognized that the Fed needed *financial* independence in order to conduct monetary policy effectively. The Fed is exempted from the congressional appropriations process in order to keep the political system from abusing its money creating powers. The central bank funds its operations from interest earnings on its portfolio of securities. The Fed was given wide latitude regarding the size and composition of its balance sheet to enable it to react quickly and independently to unanticipated short-run developments in the economy. In the early 1980s under the strong, independent leadership of Paul Volcker the Fed succeeded in establishing low inflation as the nominal anchor for monetary policy. Thus, Fed independence is today the institutional foundation for effective monetary policy.

## Asset Acquisitions Should Sustain Federal Reserve Independence<sup>7</sup>

Congress has bestowed financial independence on the Fed only because it is essential for the Fed to do its job effectively. A healthy democracy requires full public disclosure and discussion of the expenditure of public funds. The congressional appropriations process enables Congress to evaluate competing budgetary programs and to establish priorities for the allocation of public resources. Hence, the Fed—precisely because it is exempted from the appropriations process—should avoid, to the fullest extent possible, taking actions that can properly be regarded as within the province of fiscal policy and the fiscal authorities.

When the Fed purchases Treasury securities, it lends to the Treasury. Doing so leaves all the fiscal decisions to Congress and the Treasury and hence does not infringe on their fiscal policy prerogatives. Pure monetary policy as described above—the acquisition of Treasury securities with newly created bank reserves—respects the integrity of fiscal policy fully.

Federal Reserve credit policy as described above is another matter entirely, because all financial securities other than Treasuries carry some credit risk and involve the Fed in potentially controversial disputes regarding credit allocation.

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<sup>7</sup> This section draws directly from J. A. Broaddus, M. Goodfriend, “What Assets Should the Federal Reserve Buy?” Federal Reserve Bank of Richmond *Economic Quarterly* (Winter 2001), pp. 7-22.

When the Fed extends credit to private or other public entities, it is allocating credit to particular borrowers, and therefore taking a fiscal action and invading the territory of the fiscal authorities.

It is 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. The Fed must decide how widely to expand its lending reach. Fed involvement in one type of credit can drain lending from nearby credit channels. The Fed must determine the relative pricing of its loans based on risk and collateral. The Fed must be accountable for its credit allocations and the returns or losses on its loans. The public deserves transparency on Fed credit extensions beyond ordinary discount window lending to banks. Congressional oversight opens the door to political interference in the Fed's lending choices. The Fed is exposed to Congressional pressure to exploit the central bank's off-budget status to circumvent the appropriations process.

Finally, the Fed and the government must cooperate on banking, financial, and payments system policy matters. 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. Worse, the Fed could be pressured to make concessions on monetary policy to deflect pressure regarding credit policy.

## “Accord” Principles for Federal Reserve Credit Policy

The above reasoning suggests that the following principles should serve as the basis for a comprehensive Credit Policy Accord between the Treasury and the Federal Reserve. To repeat, Congress bestows Fed independence only because it is necessary for the Fed to do its job effectively. Hence, the Fed should perform only those functions that must be carried out by an independent central bank. The main idea is to preserve the Fed’s independence to act flexibly and aggressively with monetary policy and (limited) credit policy so that the Fed can make its maximum contribution to price stability, financial market and macroeconomic stability.

Principle 1: As a long run matter, a significant, sustained expansion of the Fed credit policy beyond ordinary, temporary last resort lending to banks is incompatible with sustained Fed independence. The Fed should adhere to a “Treasuries only” asset acquisition policy except for occasional and limited discount window lending to banks.

Principle 2: The Treasury and the Fed should agree to co-operate, as soon as the current credit crisis allows, to shrink the central bank’s lending reach by letting Fed credit programs run off or by moving them from the Fed’s balance sheet to be managed elsewhere in the government. Any further expansion of Fed credit programs in the current credit crisis should be undertaken by agreement with the

Treasury to minimize the risk of committing to a course of action that proves subsequently to be ill-advised.

Principle 3: The Fed has employed monetary policy in the service of credit policy in the current emergency by creating over 1 trillion dollars of bank reserves to finance its credit policy initiatives, with the possibility of more to come before the credit crisis ends. The Treasury and the Fed should co-operate so that the Fed's fiscal support through its credit policy initiatives for banking and credit markets does not undermine price stability.

Principle 4: To strengthen the nation's commitment to price stability, the Treasury and the Fed should agree on a low long run inflation objective to anchor inflation expectations against rising inflation or deflation. Such an agreement will not only improve the effectiveness of monetary policy, it will help hold down the inflation premium that the Treasury must pay to borrow long term.

Principle 5: The Treasury should help the Fed to secure the power of "interest on reserves" to put a floor under the federal funds rate. The Treasury and the Fed should do so by making sure that every institution that trades in the federal funds market holds deposits at the Fed and receives interest on those deposits as set by the Fed. This institutional fix is necessary to guarantee the Fed's operational

power to raise its federal funds rate target against inflation, regardless of the size of the Fed's balance sheet.<sup>8</sup>

Principle 6: The Treasury and the Fed should agree *as soon as possible* to co-operate as above to credibly secure the commitment to price stability so that the Fed can act preemptively, flexibly, and aggressively in the short run against either inflation, or a deepening contraction and deflation, whichever proves to be the greater risk. The credibility of monetary policy to act aggressively against deflation, if need be, depends crucially on the Fed having the power to raise interest rates against inflation if and when that should become the problem.

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<sup>8</sup> M. Goodfriend, "Interest on Reserves and Monetary Policy," Federal Reserve Bank of New York *Policy Review*, (May 2002), pp. 77-84.