The Federal Reserve: Independence Gained, Independence Lost….

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The Federal Reserve's Independence: Virtue Gained, Virtue Lost…

The Fed since its establishment in 1914 has had to struggle to maintain its independence from the Treasury and so recent experience must be viewed in historical context. The Federal Reserve Act gave the institution a considerable amount of independence from the fiscal authority. The Reserve banks could set their discount rates based on the demands by member banks to discount eligible paper. Government securities were not included in eligible paper so that the Fed, unlike the Bank of England in its early history, was not created to be a central bank to finance short run government revenue shortfalls .However the Fed was not completely independent, the Secretary of the Treasury and the Comptroller of the Currency were ex officio members of the Board.

World War I changed the picture considerably. The System quickly became involved in war finance, absorbing short-term government securities at low pegged rates and marketing war bonds, and by 1917 became an engine of inflation. Once the war ended it took the Fed two years to regain its independence during which it fueled two more years of inflation.

Although Fed officials became concerned about the run up in inflation they were unable to act without Treasury compliance. The Treasury wanted to keep interest rates low and bond prices high to protect the commercial banks, which had absorbed its debt. As a consequence, the Fed had to wait until late 1919 to raise rates, when the Treasury had completed its funding of the war debt, to stem inflationary pressure. Subsequently, the waited too long to reduce rates and by 1921 a significant recession had set in. This was perhaps the Fed's first serious policy error (Friedman and Schwartz 1963).

In the 1920s the Fed carried out an independent monetary policy based on the Burgess-Rieffler doctrine (Meltzer 2003) in what Friedman and Schwartz termed "The High Tide of the Federal Reserve". But then its flawed perception of the stock market boom helped trigger the downturn and crash of 1929. Disaster followed in the next three years when the Fed failed to use its open market policy to offset a series of banking panics. Its performance reflected a mistaken variant of the real bills doctrine and an endemic structural split between the Federal Reserve Board and the Reserve banks. Indeed the Fed's performance in the Great Contraction led Milton Friedman to propose in a 1962 essay that the Fed be made a branch of the Treasury for the purpose of following his famous k% rule.

In reaction to the Great Contraction the Fed was reorganized in the Bank Acts of 1933 and 1935. In theory the 1935 Act solidified the Fed's independence by removing the Secretary of the Treasury and the Comptroller of the Currency from the Federal Reserve Board and centralizing control in the new Board of Governors. However as Meltzer(2003) points out, although the Fed in theory had the trappings of a powerful central bank ('independent within government'), in practice it was subservient to Treasury gold policy and low interest rates from 1933 to 1951.

The one episode when the reconstituted Fed used its policy independence was in 1936-37, when it doubled reserve requirements in a mistaken attempt to mop up excess reserves in the commercial banking system. This action led to a serious recession in 1937-1938.

From 1941 to 1951 the Federal Reserve was completely subservient to the debt management policies of the Treasury. In April 1942, once World War II was underway, the System adopted an explicit peg for 90 day T –bills at 0.375% and for the 25 year bond at 2.5%. (Meltzer 2003 chap 7) describes how the Fed became an engine of inflation, initially by lending to commercial banks on the collateral of government securities at a preferred rate below the official peg; and later by directly purchasing Treasury securities. Chairman Eccles was a strong advocate of the wartime bond pegging policy and was not concerned about the impotence of monetary policy because he believed that fiscal and not monetary policy was the way to stabilize the economy. He continually pushed for an extension of the Fed's mandate to control credit to aid the war effort. After the war ended, the interest rate pegging policy was retained as were many of the panoply of controls. Officials at the Fed acquiesced to the peg and expansionary policy because of a widespread belief fostered by Keynesian doctrine and the experience following World War I that there would be a serious postwar recession.

By the end of the 1940's some Fed officials , most notably Allan Sproul, President of the New York Fed, concerned about inflation, pressed for the institutional independence to raise rates. From 1949 to 1951 there was growing conflict between the Treasury arguing for bond market stability and the Fed urging higher rates to stem inflation. The conflict ended with the famous Fed-Treasury Accord on February 26, 1951 which gave the Fed the independence to conduct its own interest rate policy.

In the 1950s under Chairman William McChesney Martin, the Fed followed sound monetary policies within an economic policy environment under the Eisenhower administration which emphasized budget balance, price stability and the Bretton Woods peg to gold at $35 an ounce. From 1959 to 1964, the Fed continued to emphasize price stability and when U.S. gold reserves came under threat, the Fed followed orthodox monetary policy and tightened (Bordo and Eichengreen 2008).

The Fed's independence came increasingly under challenge beginning in 1965. Mounting pressure from the Treasury and the Johnson Administration to coordinate monetary and fiscal policy and to follow "even keel" policies under which the Fed would hold Treasury bond prices steady to aid funding operations reduced the Fed's ability to raise rates to ward off inflationary pressure. During this period Keynesian views and belief in the Phillips curve tradeoff between inflation and unemployment gained dominance within the Fed and the U.S. government. In December 1965 after the Fed raised the discount rate to stem incipient inflationary pressure and mounting gold losses, President Johnson verbally attacked Chairman Martin (Meltzer 2010). For the rest of his tenure as Chairman, Martin was increasingly acquiescent to the Administration's demands and inflation momentum kept building up.

The Fed's performance in the 1970's under Chairman Arthur Burns and later G. William Miller was abysmal. The Fed lost its will to tighten sufficiently to completely offset the build up in inflationary expectations for fear of the political costs of rising unemployment. Indeed Burns caved in to political pressure from President Nixon to avoid tightening and raising unemployment and thereby jeopardizing the Republicans chances in the election of 1972. (Hetzel 2008).

By 1979 inflation had reached double digit levels. In August 1979 President Carter appointed a well known "inflation hawk," Paul Volcker, as Chairman of the Federal Reserve. Volcker raised the funds rate by 7 percentage points between October 1979 and April 1980, the largest increase over a 6 month period in Fed history. This tightening combined with consumer credit controls in the spring of 1980 led to a sharp recession. The Fed then shifted to an expansionary policy in July 1980 but in the face of a resurgence of inflation the Fed began to tighten again in May 1981. The FOMC policy reversal and acquiescence to political pressure in 1980 was widely viewed as a signal that the Fed was not committed to achieving a substantial decline in inflation.

The second and more durable round of tightening succeeded in reducing the inflation rate from about 10% in early 1981 to 4% in 1983 at the cost of a sharp and very prolonged recession (Bordo, Erceg, Levin and Michaels 2007). The second Volcker shock, which was supported by the Reagan administration succeeded in breaking the back of inflationary expectations. It also augured a new era of Fed independence after a 20 year hiatus. During the subsequent Great Moderation period from 1984 to 2006, the Fed demonstrated its credibility to commit to low inflation as seen by its willingness to raise the funds rate sharply in the inflation scare of 1994.

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Since the financial crisis of 2007-2008 the Fed's independence has again been challenged with echoes of the 1940s, 60s and 70s. In 2007 and 2008 the Fed worked closely with the Treasury to set up a number of discount window lending facilities to alleviate the credit crunch. Such quasi fiscal facilities provide credit directly to firms the Fed deemed most in need of liquidity and exposed the Fed to the temptation to politicize its selection of recipients of its credit. In addition, the Fed's balance sheet ballooned in 2008 and 2009 with the collateral of risky assets including those of non banks and a non financial firm, AIG. These assets were in part backed by the Treasury. The Fed also worked closely with the Treasury to stabilize major banks with capital purchases and stress testing. Moreover the purchase of mortgage backed securities and long- term Treasuries in 2009 (quantitative easing) combined monetary with fiscal policy. Finally a sense of déjà vu was evident in the close cooperation between the Chairman of the Fed and the Secretary of the Treasury in their appearances before Congress requesting financial rescue funds in the fall of 2008. All of these moves have compromised Fed independence.

The Fed was successful with its unorthodox quantitative easing policies in 2009 in stemming the recession despite compromising its independence. How will it regain its independence? It should be able to do this by: 1) terminating its credit facilities (which is underway); 2) ending its purchases of mortgage backed securities and long-term Treasuries (which is also underway); and 3) pursuing a successful exit strategy. This involves abandoning the current policy of holding the federal funds rate close to zero and returning to a neutral monetary policy. If the Fed waits too long before tightening because of the fear of high unemployment, inflationary expectations will again pick up and make restoring credibility even more difficult, a pattern that we have seen before. If the Fed were to follow the timing pattern of exits from monetary ease after recessions seen in the post World War II era in the current business cycle recovery, and if unemployment really peaked in the fourth quarter of 2009, then we should see a tightening in the first half of 2010 (Bordo and Landon Lane 2010). Although if unemployment were to decline slowly from its current elevated level, political pressure as in the past may stall the tightening longer. This outcome will make regaining Fed independence more of a challenge.

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