Boundaries Between the Fed and the Treasury

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Each institution has specific responsibilities. The Fed controls monetary policy. The Treasury controls Federal debt management. Each institution generally operates independently of the other. The Federal Reserve is authorized to buy Treasury and government agency securities only in the open market, not directly from the Treasury or other agencies. The rationale for this constraint is obvious. Its aim is to isolate the central bank from interference by other government authorities in monetary policy decisions. Spectacularly, the subject of the Federal Reserve's independence has emerged as a current issue for its leadership.

On March 23, 2009, the Treasury and the Fed issued a joint statement on the division of the economic responsibilities between the two agencies. The statement has been called the "2009 Treasury – Federal Reserve Accord."

The Treasury and the Federal Reserve agree on the following broad points:

1. Treasury-Federal Reserve cooperation in improving the functioning of credit markets and fostering financial stability

The Federal Reserve's expertise and powers are indispensable for preventing and managing financial crises. The programs it has initiated since the onset of this crisis have played a critical role in helping to contain the damage to the broader economy. As long as unusual and exigent circumstances persist, the Federal Reserve will continue to use all its tools working closely and cooperatively with the Treasury and other agencies as needed to improve the functioning of credit markets, help prevent the failure of institutions that could cause systemic damage, and to foster the stabilization and repair of the financial system.

2. The Federal Reserve to avoid credit risk and credit allocation

The Federal Reserve's lender-of-last-resort responsibilities involve lending against collateral, secured to the satisfaction of the responsible Federal Reserve Bank. Actions taken by the Federal Reserve should also aim to improve financial or credit conditions broadly, not to allocate credit to narrowly-defined sectors or classes of borrowers. Government decisions to influence the allocation of credit are the province of the fiscal authorities.

3. Need to preserve monetary stability

Actions that the Federal Reserve takes, during this period of unusual and exigent circumstances, in the pursuit of financial stability, such as loans or securities purchases that influence the size of its balance sheet, must not constrain the exercise of monetary policy as needed to foster maximum sustainable employment and price stability. Treasury has in place a special financing mechanism called the Supplementary Financing Program, which helps the Federal Reserve manage its balance sheet. In addition, the Treasury and the Federal Reserve are seeking legislative action to provide additional tools the Federal Reserve can use to sterilize the effects of its lending or securities purchases on the supply of bank reserves.

4. Need for a comprehensive resolution regime for systemically critical financial institutions

The Treasury and the Federal Reserve remain fully committed to preventing the disorderly failure of systemically critical financial institutions. To reduce the risk of future crises, the Treasury and the Federal Reserve will work with the Congress to develop a regime that will allow the U.S. government to address effectively at an early stage the potential failure of any systemically critical financial institution. As part of the framework set forth, the legislation should spell out to the extent possible the expected role of the Federal Reserve and other U.S. government agencies in such resolutions.

In the longer term and as its authorities permit, the Treasury will seek to remove from the Federal Reserve's balance sheet, or to liquidate, the so-called Maiden Lane facilities made by the Federal Reserve as part of efforts to stabilize systemically critical financial institutions.

The statement's stress on the importance of independence for the central bank reflects the lesson of intervention by governments in policy decisions affecting money and prices that may conflict with general government policies with respect to financing projects assigned a high priority for political objectives. This is the basic motive for isolating the central bank's activities from those of the Treasury. The Treasury stands for political pressure that may be harmful to the public interest in maintaining a sound money policy that the central bank presumably aims to serve.

The occasion for the joint statement, possibly in response to Federal Reserve apprehensions that its close cooperation with the Treasury during both the Bush and Obama administrations had raised widespread suspicion that the Fed was not truly independent. Internal discussion within the Fed on this issue focused on the future need for the central bank to tighten monetary policy when the recession had ended and inflation required control. How would the administration respond to such action by the Fed, especially if the unemployment rate is still elevated? The joint statement was one way of giving public expression to the Fed's worry that its independence might be threatened. Another aspect of the problems that could arise with a program of monetary tightening was the condition of the Fed's balance sheet. It usually held enough Treasury securities that it could sell when it tightened. During this recession, however, the Fed's holdings of Treasury had declined, because it accepted as collateral for loans it extended to financial institutions, toxic assets, which had no market if the Fed wanted to use them in tightening. The Treasury meanwhile introduced a facility to provide the Federal Reserve with Treasury securities. The Fed now has proposed a different solution. It has announced that it will seek Congressional legislation authorizing it to sell its own debt. For the time being, however, the Fed must rely on the joint statement as the bulwark of its ability to conduct monetary policy in accordance with its own decisions.

It may be of some surprise that Milton Friedman, a believer in limited government, proposed subordinating the Fed to the Treasury department not as an ideal but as an improvement of existing arrangements. He contended that it would result in a single locus of power on monetary and fiscal policies, and would establish accountability for mistakes in policy that otherwise leave each institution free to blame the other for policy errors.

According to Friedman, even if there were a central bank that had independence to the furthest extent, it would still be independent only if it had no conflict with the rest of government. If there were a conflict, the bank would unquestionably give way to the fiscal authorities. He goes further, stating that even if a fully independent bank could be established, it would not be desirable to do so for political and technical reasons. The political reason is that in a democracy it would be wrong to place such concentrated power in a group free from any kind of direct political control. "The rule of law rather than of men is hard to reconcile with the approval of an independent central bank in any meaningful way. The kind of limited discretion left by even the best of laws in the hands of those administering them is a far cry indeed from the kind of far-reaching powers that the laws establishing central banks generally place in the hands of a small number of men" (1987, 434-5).

Friedman's technical reason for opposing central bank independence is that at its founding, the monetary regime under which the Fed operated was the gold standard. The overriding objective of the Fed was to maintain the fixed rate of exchange between the dollar and other countries' currencies. Central bank independence was a technicality. Once the gold standard lost its dominant features, independence became meaningful.

Friedman points to the fact that in terms of the functions performed, the Fed was hardly ever the sole authority in the government that had essential monetary powers. Before the Fed existed, the Treasury exercised essential monetary powers, and at times similar to those of a central bank. From 1933 to 1941, the Fed was passive and the Treasury predominantly took over monetary powers and engaged in open market operations of buying and selling securities. It created and destroyed money in its gold and silver purchases and sales. It used the Exchange Stabilization Fund as another device for engaging in open market operations. In sterilizing it engaged in monetary actions.

The Fed printed money and made book entries called money, and had control over these limited monetary matters.

Friedman lists three more technical defects of an independent central bank: shirking responsibility in times of uncertainty and difficulty; dependence on personalities which fosters instability; subject to undue influence to the opinions of bankers. The connection between the central bank and the banking community obfuscates the difference between problems the central bank faces in the credit market and the problems of monetary policy.

According to Friedman, it would be much more efficient if the Fed did all the borrowing and all of the managing of the debt and the Treasury, when it had a deficit, financed it by getting money from the Fed, and when it had a surplus handed it over to the Fed.

I do not agree with Friedman's definition of the optimal relationship between the Treasury and the Fed. It concedes supremacy to the Treasury to a greater extent than the Fed accorded voluntarily to it in agreeing to even keel, according to which the Fed refrained from changing credit conditions in the market during the interval when the Treasury was issuing a new security.

I believe the Treasury's policies during peacetime are not necessarily preferable to monetary policies that give priority to maintaining the purchasing power of the currency over the long run. The Fed is more immune to political pressure than the Treasury is. Political control in the hands of uninformed legislators is hardly the summum bonum of a monetary system that provides financial stability and public trust of financial activity.

References

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