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Politics and the Fed

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In the standard economic model of policy choice, choices are made by analyzing the social welfare implications to find welfare optimizing policy choices. In this paper, I argue that in a democratic government, and perhaps elsewhere, policy choices emerge from a political process. People vote; the voting process chooses elected representatives. With their appointees the representatives make policy choices. The appropriate model for policy analysis is a political economy model.

This conclusion is reinforced by my fifteen years of studying the history of the Federal Reserve.[1] From the start, that study reflected the influence of James Buchanan and many others who followed him by analyzing policy choices made by individuals or committees motivated by considerations other than optimal welfare. Some of my prior work with Alex Cukierman and Scott Richard is fully in that tradition. (Meltzer, Cukierman and Richard, 1991)

Consider recent Federal Reserve policy. The Federal Reserve has more than doubled the size of its balance sheet. It has more than $1 trillion of excess reserves and more than $1 trillion of long-term, relatively illiquid mortgage-backed securities. No central bank in a developed country ever had so much long-term debt. In 1932, a much less informed Federal Reserve Board refused a request from Congress to support the mortgage market. Congress responded by creating the Home Loan Banks, a fiscal solution. The current Board undertook the fiscal operations. This is a political decision. Who would claim it is optimal policy?

In the late 1970s, Congress gave the Federal Reserve a dual mandate. Except for the years of "moderation", it has acted lexicographically. From 1979 to 1982, it pursued disinflation, letting unemployment rise to 10.8 percent. Before 1979, it concentrated on

[1] I an greatly indebted to the librarians at the Board of Governors and the archivists at the New York Federal Reserve bank for their help, to the American Enterprise Institute for the support of excellent research assistants, and to the many readers who commented on the manuscript especially Anna Schwartz and David Lindsey.

unemployment letting measured rates of inflation reach double digits. Currently, reducing unemployment is the main goal; inflation can wait.

Who would claim that the optimal way to achieve a dual goal is always to work on one objective at a time? I cannot establish that the Federal Reserve follows inefficient procedures for political reasons, but I believe that the absence of a rule or quasi-rule and reluctance to ask Congress to approve so-called inflation targeting is best explained as a political decision. Policy and politics have a common Greek root.

Current politicized actions are not a rare event. Purchases, basically fiscal actions, are larger than in the past, but through most of its 96-year history, the Federal Reserve has often responded to political pressures. Federal Reserve actions affect economic outcomes. Voters hold elected officials, not Federal Reserve officials, responsible.

The Federal Reserve is a major economic policy institution, but it is also a political institution. When Congress created the Federal Reserve in 1913, it gave no thought to optimal welfare policy. Its central concern was how the benefits of having a central bank would be distributed. Bankers wanted a bank modeled on the Bank of England; decisions would be made by bankers and they would benefit from having a place to rediscount loans and an opportunity to compete more effectively with London banks for the financing of agricultural exports. The principal opposition to the bankers came from farmers and others who feared that control by bankers would not be in their interest. They preferred government control.

President Woodrow Wilson arranged a compromise. Congress made the 12 regional banks "semi-autonomous." The Board in Washington had a supervisory role. From the very start, the Board and the Reserve Banks differed over decision making. One of the earliest tussles came when the banks organized a Governors Conference in 1915 that began to meet at one of the banks to decide on policy and other matters. The Board decided that the banks had "assumed powers which they did not possess." (Meltzer, 2003, 80) They ordered the banks to meet in Washington no more than four times a year, to hold informal discussions, and it refused to approve spending for a staff. This was the first of many political disputes about governance.

The Board won the early conflict, but the conflict continued. Prior to the Great Depression, Reserve Bank directors could approve or refuse to accept their share of securities purchases or sales. In the 1920s, the banks agreed to coordinate purchases and sales under the leadership of Benjamin Strong and the New York bank. They created an open market committee that the 1913 act did not authorize. The Board had no vote on open market purchases or sales. It used its supervisory authority to veto decisions it opposed. Several Board members disliked that arrangement. They found it too restrictive of their power. Soon after Benjamin Strong retired in 1928, the Board expanded the size of the open market committee. In 1935, Congress amended the Federal Reserve Act to authorize a Federal Open Market Committee (FOMC) and gave the Board a majority of votes. New York continued to carry out policy operations, but Board Chairman Eccles did not like the New York president, so until 1942 New York was not given a permanent seat on the FOMC. From 1935 to 1942, Boston declined rotation to permit New York to serve.

The 1935 amendments to the 1913 act changed the formal locus of power in the system. The Board did not act to take control until the 1950s. In a series of decisions, Chairman Martin ended arrangements that allowed New York to dominate FOMC purchase and sale decisions. By 1955 at the latest, the Board had taken charge. Changes in the locus of power affect the choice of policies. It is a political act aimed at concentrating power at the Board.

Soon after, members of Congress began to express greater interest in monetary policy. They pressed for greater transparency, audits of the FOMC, changes in the membership of bank boards to include labor, minorities, and women, Senate confirmation of Reserve Bank presidents, and changes in the power of Reserve Bank presidents. The system opposed many of the changes often calling on bankers to oppose changes. When Chairman Arthur Burns encouraged banker pressure on members of Congress, Congress reacted angrily.

These differences often reflect the same division that President Wilson tried to settle, differences between bankers and regional interests versus national political interests represented in the Congress or usually the Chairs of the Banking Committees. Many of these issues and conflicts are present currently.

Behind these disputes over power and influence, there are three main issues active at different times. First is the economic model or framework that the FOMC uses. The second, often related to the first, is the weights given to inflation, the exchange rate, and the unemployment rate in policy decisions. Third, Chairman Martin often said that the Congress often adopted a budget with a deficit. He believed that an independent Federal Reserve had to assist in financing the debt. It is hard to find evidence of optimal policy in the resolution of these issues.

Early Political Intervention

The original Federal Reserve Act was based on the gold standard and the real bills doctrine. The latter authorized discounting of commercial paper used to finance agriculture, industry, and trade. That restriction ruled out purchases of government securities, direct finance of the Treasury, loans to brokers and dealers operating on exchanges, or mortgage securities.

Real bills advocates claimed that by restricting the quality of credit they could prevent inflation. The flawed argument was that discounts of commercial paper increased when producers increased production and inventories. The increase was temporary, repaid when the producer sold the product, so prices would not rise.

The Governor of the New York bank, Benjamin Strong, recognized the fallacy in the real bills doctrine.[2] Restricting discounts to real bills restricted the portfolios of the Federal Reserve banks but not the end use that banks made of credit. Board members continued to insist on applying the real bills doctrine. The difference was central to the policy disputes between the Board and the banks in the 1920s and 1928-29. Board members would not approve increases in the discount rate requested by several Reserve Banks, especially New York. Board members did not forget Congressional ire at the use of discount rate increases in the 1920-21 deflation. Instead, the Board sent a letter to the member banks urging them to prevent the use of credit for stock exchange speculation. The real bills doctrine was one reason for the Board's action. Reluctance to raise the discount rate above 6 percent was a political reason that supplemented real bills.

Financing World War I gave the system a political reason for circumventing the real bills doctrine. Instead of buying government securities as in World War II, the system ensured the success of four Treasury bond drives by offering short-term loans at preferential discount rates that financed commercial bank purchases of Treasury certificates during the intervals between bond drives. During bond drives, the Federal Reserve adopted the so-called "borrow and buy" policy. The policy permitted banks to defer payments for bond purchases up to a year from the time of purchase. Instead of raising market rates, the Board and the Treasury chose to subsidize the banks. Optimal or political?

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[2] Until 1935, the operating head of each Reserve Bank had the title governor. After 1935, Board members became governors and heads of Reserve Banks became presidents.

Many in the system understood that circumventing the real bills doctrine to finance government bond sales was inflationary. After the war, some but not all members wanted to eliminate the preferential discount rate that banks used to finance Treasury purchases. The Treasury did not agree until much later. In the classic pattern followed by debt managers, the Treasury wanted to keep discount rates low to prevent an increase in the rates it paid to lenders. A compromise with the Treasury permitted a rate increase after the Treasury sold certificates. This was not optimal for the buyers. And the Treasury did not accept an increase in the preferential rate for borrowers who purchased Treasury certificates. The Federal Reserve found itself unwilling to raise interest rates when faced with Treasury opposition. The Treasury's preferential rate remained until the end of the Wilson presidency. The same problem reoccurred after World War II.

One difference after the two wars was that in 1918 and 1919 the Treasury Secretary and the Comptroller of the Currency were Board members. The Board waited for a signal from the Treasury before notifying the banks about rate changes. The preferential rate remained until inflation and loss of gold threatened the gold reserve requirement.

Experience following World War I shows that political influence had a powerful effect at the time. It was a prelude to many other periods when political influence prevented the system from taking appropriate action.

The real bills doctrine was not the only source of disagreement between the Board and the Reserve banks. Congress had criticized the Board for increasing interest rates to 6 percent in 1921 and authorizing penalty interest rates on marginal increases in borrowing.[3] The highest rate was 81.5 percent on a small loan at the Atlanta bank; it does not require deep knowledge of politics to recognize what politicians and the press did to an 81.5 percent rate. Maximum rates at St. Louis, Dallas, and Kansas City were 16, 7 and 22.5 percent respectively. The fact that the four Reserve Banks that introduced marginal rates were in agricultural districts reopened a recurrent political charge. Critics claimed that just as they feared the system worked to raise interest rates to farmers and merchants above the rates paid by banks and brokers in Wall Street.

[3] Each member bank had a "normal" borrowing amount based mainly on size. Borrowing in excess of normal could be charged a higher, progressive rate. Only four districts, Atlanta, St. Louis, Dallas and Kansas City introduced progressive discount rates.

Congress responded by amending the Federal Reserve Act. An additional member to represent agriculture joined the Federal Reserve Board. There were now eight Board members including the two ex-officio members.

Deflation was the next major problem. Prices increased during the war and early postwar. Governor Strong and his British counterpart, Montagu Norman, wanted to restore the prewar gold standard. They decided that both countries had to deflate to the prewar price level, so they undertook deflationary policies. The wholesale price index shows that prices in the United States had increased in response to the prewar gold inflow and wartime monetary expansion. The deflation from 1920 to 1922 lowered the wholesale price index almost 40 percent to the pre-war level.[4]

Strong knew that deflation would be costly. He expected unemployment to rise, but he (and Norman) regarded the cost as necessary to restore the gold standard. Deflation and the high interest rates in agricultural regions brought a Congressional inquiry. Strong succeeded in shifting the blame for interest rates onto the Treasury and making the case that deflation had to follow inflation. The lasting effect of the Congressional inquiry and criticism throughout the country was reluctance to increase the discount rate above six percent and a firm belief that the Federal Reserve could not follow Bank of England discount rate policy. To control credit, the system began to rely on open market purchases and sales. Instead of encouraging and discouraging borrowing by changing the discount rate, the system encouraged borrowing or forced repayment by selling and buying commercial paper. It nurtured the belief that banks were reluctant to borrow, so it said credit contracted following increased borrowing because banks did not want to be in debt. This “needs and reluctance” explanation persisted for decades – long after facts showed that banks responded to profit opportunities reflected in interest rates above the discount rate.

The severe 1921 deflation brought short-term real interest rates to 30 percent or more. Gold flowed in. Monetary base growth rose and recovery followed. The 1920 deflation was more severe than many others, but economic expansion always followed monetary expansion. The severe 1929-32 deflation is not an exception. It differed mainly because money growth declined much more than the rate of price change. Until President Roosevelt stopped the

[4] Other broad-based price indexes became available much later. They show a comparable reduction to pre-1917 levels.

monetary decline by devaluing the gold dollar, the expectation of further deflation remained. After the dollar was devalued in January 1934, the political decision to devalue the dollar ended deflation.

The Federal Reserve and the Treasury, 1934-1951

During the long recovery from the Great Depression, the Federal Reserve either did nothing or remained subservient to the Treasury much of the time. Treasury Secretary Morgenthau wanted low interest rates to finance deficits. At times, he threatened to use the Exchange Stabilization Fund to conduct open market purchases. The Federal Reserve did not want the Treasury to take over its responsibilities, so they agreed to Morgenthau's demands.

The Federal Reserve's decision to slow reserve growth in 1936 and 1937 was not an independent action. The Treasury made the decision to sterilize gold inflows urged on by President Roosevelt's wish to reduce speculative gold inflows. (Meltzer, 2003, 505) Sterilization worked like an open market sale of securities combined with a gold purchase. The Federal Reserve contributed increases in reserve requirement ratios.

Before the second and third increases in reserve requirement ratios, the Board got Treasury agreement to the change. In January 1937, the Board met with Morgenthau. Although Morgenthau expressed reservations, he gave his approval to the second increase (ibid., 507-8). The Treasury also approved the decision to divide the remaining change in reserve ratios into two parts, one in February and one in May.

Between the two increases, rates rose in the bond market. Although the rise was small, Morgenthau was very upset. He described the increase as a panic when rates reached 2.52 percent on March 13, 1937. He blamed the Federal Reserve and demanded that the Federal Reserve purchase enough to increase reserves and raise the bond rate to par at 2.50 percent. The Board then met in Morgenthau's office. The Federal Reserve agreed to hold an FOMC meeting on March 15. The meeting agreed to purchase bonds but offset the purchases by selling bills. Eccles and Morgenthau wanted larger purchases, up to $250 million, a 10 percent increase in Federal Reserve holdings, but the FOMC, remembering it is supposed to be an independent agency, did not agree.

Independence did not last. Morgenthau threatened to use the Exchange Stabilization Fund. At an evening meeting of the FOMC at Morgenthau's home, Morgenthau warned that either the FOMC would act or the government would. The next day, April 4, the FOMC agreed to purchase $25 million at once and $250 million by May 1. Purchases started the next day. These were the first open market purchases since November 1933.

The 1937-38 recession began soon after these discussions ended. Eccles urged increased government spending, but did not make any net purchases until 1938. Morgenthau and the Treasury wanted to end gold sterilization and reduce reserve requirement ratios. In February 1938, Roosevelt agreed to end gold sterilization. Eccles was, at best, cool to the idea. At the FOMC's March 1 meeting, he favored continuing the Federal Reserve's program of selling long-term debt and purchasing bills. Eccles opposed proposals for net sales to reduce excess reserves, but did not urge net purchases.

The Federal Reserve remained on the sidelines. The Treasury's decision to end gold sterilization beginning in February 1938 expanded the monetary base and helped to end the recession. In April, after the recession ended, the Federal Reserve reduced reserve requirement ratios. The Board's minutes refer to the change as part of the president's program. (Board Minutes, April 13, 1938, 1-2)

Shortly after the United States entered World War II, on April 30, 1942, the Federal Reserve announced that it would purchase all 90-day Treasury bills offered at a rate no higher than 0.375 percent per annum. Initially it did not peg rates on other securities explicitly, but it maintained a pattern of rates throughout the war. The highest rate was 2.5 percent on bonds with initial maturity of 25 years. During the war and early postwar, the duration of debt at the largest banks declined, but the maximum yield remained at 2.5 percent.

The Federal Reserve did not expect to maintain the wartime rate structure after the war. The Treasury agreed to increase some of the short-term rates, but it wanted the 2.5 percent long rate to remain. Political concerns limited the Federal Reserve's ability to respond to postwar inflation. At times, they complained to each other about the restriction, but they did not believe they had political support for an independent policy.

The Federal Reserve shared the widespread concern among economists that the presence of a large, outstanding public debt limited the role of monetary policy. Increases in interest rates would reduce the value of outstanding debt. President Truman was not alone in his concern that a rise in interest rates would reproduce the severe deflation of 1920-21 that caused his haberdashery to fail. Chairman Eccles used this mix of political and economic argument to conclude that the Federal Reserve had to wait until the public supported higher interest rates.

The Treasury's position was more extreme than after World War I. Then, Treasury wanted no changes as long as it had to undertake large-scale financing. After World War II, the budget had a surplus by spring 1946, so Treasury could retire debt. Nevertheless, it opposed any change in wartime interest rates.

Two political events brought change. Senator Paul Douglas became chairman of the Joint Economic Committee. Douglas, a former distinguished economics professor at the University of Chicago, wanted the Federal Reserve to be more independent of the Treasury. Joined by Senator Ralph Flanders and Congressman Jesse Wolcott, Douglas gave the Federal Reserve an opportunity to speak publicly in favor of independence. Chairman Eccles had often said that the system could not act independently without Congressional support. The Douglas hearings showed that leaders in the Congress supported an end to pegged interest rates.

Still, the Federal Reserve delayed. Testimony by Federal Reserve officials did not present a uniform view of the system's role. Eccles saw the Federal Reserve as mainly a government agency regulating the financial industry and carrying out government policy. Alan Sproul, President of the New York bank, saw the Federal Reserve as mainly a financial institution, blending public and private control. Although much had changed since President Wilson's 1913 compromise, the split between political and non-political control remained.

Testimony by Sproul and Eccles shows that both recognized a political constraint. Sproul said that the system had to balance the political concerns from Washington with financial concerns. (Subcommittees on Monetary Credit and Fiscal Policies, 1950, 444-45)[5] Eccles held a more political view of the Federal Reserve as an agent of Congress. "Congress appropriates the money; they levy the taxes; they determine whether or not there should be deficit financing. The Treasury is charged with the responsibility of raising whatever funds the government needs to meet its requirements. … I do not believe it is consistent to have an agent so independent that it can undertake, if it chooses, to defeat the financing of a large deficit, which is a policy of the Congress." (ibid., 231)

[5] All the materials referenced in my volumes are available on the website of the Federal Reserve Bank of St. Louis. I am grateful to them for making all the materials available.

The Korean War was the second event fostering policy change. The Federal Reserve succeeded in getting the Treasury to end the 2.5 percent interest rate ceiling.

Shortly after the Korean War started late in June 1950, the FOMC met to discuss war finance. The war increased military spending and awakened fears of inflation. Instead of voting to raise interest rates, the FOMC drafted a letter to Secretary Snyder asking him to agree to an issue of 2.5 percent bonds ineligible for bank purchase. The committee hoped to reduce short-term issues and raise the short-term rate. Snyder's reply emphasized the need to keep rates stable and the importance of leaving short-term rates unchanged.

The Board informed Snyder that it had approved an increase in discount rates to 1.75 percent, the first increase in two years. Snyder would not yield. He responded by announcing sale of a 13-month 1.75 percent note, clearly in conflict with the Board's discount rate decision. The Treasury issue failed, so the Board bought $8 billion of the $13 billion refunded.

Throughout the fall, the Federal Reserve repeatedly urged the Treasury to issue the 2.5 percent bond, and the Treasury refused. Allan Sproul urged the FOMC to increase the 1 year rate to 1.75 percent while holding the long rate at the 2.5 percent ceiling. They warned Snyder about rising inflation and the cost of inflation for government procurement. Snyder continued to oppose rate increases.

Looking back on this period after a year, the Board wrote that it had started a credit restraint program. It failed because the "policy could not be followed far enough to make the discount rate effective." (Quoted in Meltzer 2003, 697) In other words, the Board was not willing to insist on an independent policy. Politics overrode anti-inflation policy.

Conflict between the Federal Reserve and the Treasury increased and became open during the fall of 1950. The issue reached a climax after Snyder and Federal Reserve Chairman McCabe met with President Truman. After the meeting, Snyder in a speech in New York claimed that the 2.5 percent ceiling would remain. His claim went far beyond McCabe's statements to President Truman. The speech greatly strengthened the position of those like Sproul who wanted to end support for the interest rate peg.

On January 31, the entire FOMC met with President Truman. The FOMC members met before the meeting but did not agree on a common position. They let Chairman McCabe speak for the group. Neither the president nor McCabe mentioned the dispute with the Treasury. Following the meeting, the White House released a statement saying that the Federal Reserve agreed to maintain stability of the government securities market. Treasury followed with a statement that interest rate levels would be maintained during the Korean War.

The Treasury lied. The FOMC had not agreed to maintain the rate, and the president had not asked for a commitment. Most of the FOMC members were angry. One of the members had kept notes of the meeting with the president. Marriner Eccles released the notes to the press. The Sunday papers reported that the president and Secretary Snyder had lied. The conflict moved toward a political settlement known as the Accord that ended pegged interest rates.

Four factors worked for the Federal Reserve's benefit. First, Defense Secretary Wilson shared concern about inflation and the rising cost of fighting the war. Second, the financial press sided with the Federal Reserve and opposed the Treasury. Third, some Senators, led by Douglas, wanted more Federal Reserve independence. Fourth, inflation was rising. In December 1950, consumer prices rose at a 14 percent annual rate.

In the subsequent negotiation between the Federal Reserve and the Treasury, the Treasury representatives accepted the Federal Reserve proposal. The Accord in March 1951 was a political agreement. No one mentioned optimal policy.

The Accord did not grant unlimited independence. The Federal Reserve agreed to share responsibility for the orderly marketing of government debt, and it agreed to make no change in discount rates for a year without Treasury approval. The Federal Reserve also agreed to purchase up to $200 million of 2.5 percent bonds during the next refunding. The Treasury agreed to let short-term rates rise and to permit an exchange of longer-term debt at a rate above 2.5 percent.

The Martin Years, 1951-1970

Once the chance of agreement rose, Thomas McCabe resigned as Chairman. President Truman appointed William McChesney Martin. Martin negotiated the Accord for the Treasury, so he was familiar with the central issue. Also, his father served as Governor of the St. Louis Reserve Bank for many years.

Martin inherited an agency that had not pursued an independent policy since 1933. In the intervening years, the Federal Reserve had become the world's principal monetary authority. After the war, Congress passed two major pieces of legislation that affected the Federal Reserve. The Employment Act of 1946 contained a vague mandate to direct government policy to achieving “maximum employment and purchasing power.” The 1944 Bretton Woods Agreement established a system of fixed but adjustable exchange based on the $35 dollar gold price. If anyone in government saw a potential for conflict between the two laws, I have not found it.

In practice, Congress learned that the Federal Reserve could increase employment by reducing interest rates. The Federal Reserve gradually accepted responsibility for maintaining “full employment.” Until 1976, when Alan Greenspan was Chairman of the Council of Economic Advisers, the Federal Reserve and other agencies defined full employment as a 4 percent unemployment rate. They did not adjust for demographic or other changes.

The Bretton Woods commitment to maintain the $35 gold price called for actions to prevent inflation. The Federal Reserve decided that the Treasury was responsible for international policy; its role was secondary or tertiary.

Chairman Martin explained many times that the Federal Reserve was independent within the government, not independent of the government. Like Eccles he explained that the Federal Reserve could raise interest rates to prevent a boom in private investment spending, and he suggested that it was obligated to do so. But government budget deficits were different. Congress approved the budget and authorized the deficit. The Federal Reserve had to help finance the deficit. Many economists praised this conclusion. They wanted coordinated monetary and fiscal policies. They ignored politics, but politics was a dominant influence on Federal Reserve policy.

The 1951 Accord reduced the Treasury’s influence over the Federal Reserve’s actions but did not eliminate it. The Federal Reserve agreed to help with Treasury financings. Assistance took the form of “even keel” policy. The Federal Reserve kept interest rate constant for a week or two before and after a sale of Treasury notes or bonds. Even keel did little harm during the Eisenhower and Kennedy administrations because, except in recession, the budget had a surplus or a relatively small deficit. Both presidents pursued budget policies that did not cause excessive monetary expansion.

The Johnson administration followed a much more expansive fiscal policy with large deficits to finance the war in Vietnam and the Great Society. Chairman Martin’s policies produced inflation. He coordinated policy by financing a large part of the budget deficit with new money.

By 1966, economic expansion had restored high employment. Annual base money growth rose to 6 percent or above, and the funds rate reached 4.9 percent in May 1966. After May, base growth declined but the funds rate continued to rise reaching 5¾ percent in November. Regulation Q ceilings restricted banks from raising time deposit rates. As open market rates rose, holders of thrift association certificates of deposit transferred their deposits to banks. The Board made a political decision to keep the ceiling rate fixed.

Faced with declining deposit growth, the thrifts curtailed lending to home builders. Building activity declined by 40 percent in 1966. Bank loans went mostly to business customers, not to home builders. Further, banks sold their state and local government securities to service business customers. This raised rates on tax-exempt debt angering an important political group.

Thrifts and homebuilders are found in every Congressional district. They complained that they were being forced to bear the cost of financing the war and reducing the 4.8 percent inflation in early 1966. The thrifts were unwilling to raise deposit rates because they would have to pay the higher rate on all deposits. State and local governments complained to Congress about higher interest rates.

After Congress held hearings, the Federal Reserve looked for ways to control inflation that did not require higher interest rates at thrifts and small banks. In response to Congressional criticism, the Board raised the reserve requirement ratio for time deposits from 4 to 5 percentage points for banks with more than $5 million of time deposits but not for smaller banks. And it wrote a letter to member banks restricting the use of discounts by banks financing the run-off of certificates of deposit.

With the funds rate at 5.75 percent, in July the Board rejected requests for a 5 percent discount rate from New York, Cleveland, Chicago and St. Louis. Governor Daane gave his reason for voting no. "Every economic ground said to increase the rate; his reluctance was because such an action would be harmful to relationships with the Administration." (Meltzer, 2010, Book 1, 505)

A year later, Treasury Secretary Fowler and Council Chairman Ackley lobbied Board members Daane, Brimmer, Robertson, and Maisel not to increase the discount rate. They voted against the increase and it did not pass.

Many in Congress disliked the rise in market interest rates. In August 1967 the House Banking Committee approved a bill putting a 4.5 percent ceiling on interest paid on time deposits under $100,000 and a 5.5 percent ceiling over that limit. Higher rates could be offered only if the president approved.

The bill failed in the Senate, but the threat remained. Future Board actions could not ignore the political response to higher interest rates. Although Chairman Martin made frequent speeches about inflationary dangers, he left office at the end of January 1970 with the twelve-month rate of increase in the consumer price index at 6 percent. Much higher inflation came later, but 6 percent was considered a high rate of peacetime inflation.

Three political discussions dominated Federal Reserve policy during the Martin chairmanship. First, Chairman Martin and many others accepted the restricted meaning of independence that Martin often repeated and also the threat of Congressional interfering. Second, the Federal Reserve opposed securities auctions, and the Treasury did not begin auctions for notes and bonds until the 1970s. The Federal Reserve's even keel periods came very frequently. The system supplied reserves to maintain interest rates and bought unsold bonds when an issue failed to attract buyers. The reserves remained on the Federal Reserve balance sheet permitting excessive money growth. Third, the Federal Reserve accepted academic arguments supporting policy coordination. To the administration, coordination meant that the Federal Reserve would keep interest rates from rising when budget deficits increased. Chairman Martin and many others at the Federal Reserve believed that coordination also required the administration to increase tax rates to reduce deficits instead of asking for Federal Reserve purchases.

From 1966 to 1968, Chairman Martin repeatedly urged President Johnson to adopt a surtax. Johnson did not act, in part because Congress demanded spending reductions on Great Society programs. The president would not tell Martin or the public how much war spending and the budget deficit would increase. Martin learned from his own sources and again urged the president to ask for a surtax. He made a speech at Columbia University in June 1967 comparing the then current policy problem to 1929. Although he warned about the dangers of inflation, in September he voted against his colleagues on FOMC who urged an interest rate increase. Martin explained that he had worked for collaboration and did not want to oppose the president. Political concerns again dominated policy action.

President Johnson often told Martin that he disliked "high" interest rates. Chairman Martin often told him that interest rates would be lower if Congress reduced the deficit by passing the surtax. In the spring the president agreed to reduce spending by $6 billion in fiscal 1969 as part of a bill to impose a ten percent surtax.

Within days following passage, Council Chairman Arthur Okun warned the president about "fiscal overkill." Okun and others tried to convert Martin's claim that interest rates would decline once the surtax passed into a decision to lower the funds rate. The administration and the Board's staff forecast a marked slowing in the economy.

The Board's staff report to the FOMC in July urged lower interest rates to prevent slow growth. FOMC members who favored policy coordination urged action to offset some of the contractive effects of the surtax. President Galusha (Minneapolis) thought it would be "unwise … both economically and (perhaps more importantly) politically to delay easing." (Quoted in Meltzer, 2010, Book 1, 544) In August, the Board sent Governor Daane to the Minneapolis Board meeting to urge a reduction in the discount rate from 5.5 to 5 percent. The directors voted for 5.25 percent.

Directors at Philadelphia and New York would not go along. Some Philadelphia directors said "they would be willing to countenance a certain degree of economic downturn in order to bring inflation under control." (ibid., 545) This was heresy for a majority of the Board. On a 4 to 3 vote, the Board approved the 5.25 percent rate. Martin asked for, and got, a unanimous vote for the change. Several banks refused to follow.

Despite rising inflation and little evidence of slower growth, Okun tried to pressure the system to lower rates. He suggested the president appoint a commission to recommend changes in the Federal Reserve Act. In November, the commission reported. It recommended excluding the Reserve Banks from the FOMC. That would remove the strong proponents of anti-inflation policy.

The FOMC did not reverse policy until after the November election. Faced with market rates of 6.25 percent and 4.6 percent reported inflation, the Board approved a 5.5 percent discount rate, restoring the earlier 0.25 percentage point reduction.

The forecasts of "fiscal overkill" were wrong. Okun later acknowledged the error. Asked about coordinated monetary policy, Okun replied: "If anything, we were pushing them harder for more easing, and we were off." (Hargrove and Morley, 1984, 307) Some of the Reserve Bank presidents resisted the pressure, reducing the Board's ability to respond to political pressure.

Other political interventions in Federal Reserve policy affected minor as well as major decisions. In 1969, some members of Congress wanted the Federal Reserve to assist housing by buying agency securities issued to finance government mortgage purchases. The FOMC was reluctant but feared that Congress would mandate action. Chairman Martin said he was "saddened by the fact that the System was involved in a political matter whether it liked it or not." (Quoted in Meltzer, 2010, Book 1, n. 133) Purchases were substantially smaller than the more than $1 trillion of mortgage backed securities bought by the Federal Reserve in the year to January 2010. Two differences are that Chairman Martin limited the purchases and recognized that central banks in developed countries did not load their balance sheet with illiquid long-term debt. The current Federal Reserve is more influenced by political pressures.

The Burns Years

In February 1970, Arthur Burns replaced Martin as Board chairman. At his swearing in ceremony, President Nixon acknowledged Federal Reserve independence but added that he hoped they would independently decide to support him. The president left no doubt that he expected the system to do as he wished.

Burns met with the president frequently. Early in his tenure at the Board, the economy was in the 1969-70 recession. The recession did not eliminate inflation. Burns concluded that economic laws had changed. He blamed monopoly unions, oligopolies, and the welfare state. In my history, I discuss these errors. One of the main errors was neglect of expectations. Markets learned that the Federal Reserve responded quickly and decisively to unemployment but slowly and hesitantly to inflation. That produced the phenomenon known as stagflation. Burns and many others said, economics failed because inflation declined very little during recessions.

In the 1960s, Burns criticized the use of wage-price guideposts. In office, he became the leading proponent. Eventually, President Nixon imposed price and wage controls for political reasons. The Democrats in Congress authorized him to use controls. He believed they would criticize his failure to use them in the 1972 election. Burns participated in the meeting at Camp David in August 1971 at which the president prepared for a 90-day price and wage freeze and an end to convertibility of the dollar into gold. Why was the chairman of the independent Federal Reserve at a meeting to decide on economic policy to prepare for the 1972 election?

Burns answered the question in a meeting with the president recorded on President Nixon's tapes. Burns said:

> "I am a dedicated man to serve the health and strength of our national economy, and I have done everything in my power, as I see it, to help you as president, your reputation and standing in American life and history. … I want you to know this … the moment a conflict arises, I'm going to be right here. I'll tell you about it, and we'll talk it out and try to decide together where to go next." (Quoted in Meltzer, 2010, Book 1, 635).

During the fall of 1971, the president urged Burns repeatedly to increase money growth. Burns never said, yes I will. The closest he came was to tell the president that he would not repeat the Federal Reserve's 1960 monetary restriction. Money growth rose in 1972. All the remaining members of the Board of Governors had been appointed by Presidents' Kennedy and Johnson. They had no desire to help President Nixon's re-election. They voted for the policy to reduce the unemployment rate. Burns shared their concern about unemployment, and President Nixon said that no election was lost because of inflation. He said repeatedly that he lost the close 1960 election to Kennedy because unemployment rose in October 1960.

Federal Reserve actions in 1972 helped to lower the unemployment rate before the election. Burns acted for political reasons and from a desire to lower the unemployment rate for reasons he believed were consistent with increased economic welfare.

After President Carter did not reappoint Burns, Burns gave the Per Jacobson lecture at the 1979 IMF meeting in Belgrade. His speech, "The Agony of a Central Banker" contained this explanation of his actions as chairman and a message for economists who disregard political influence on policy decisions.

> "Viewed in the abstract, the Federal Reserve had the power to abort the inflation at its incipient stage fifteen years ago [1964] or at any later point, and it has the power to end it today [1979]. At any time within that period, it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay. It did not do so because the Federal Reserve was itself caught up in the *philosophic and political* currents that were transforming American life and culture" (Quoted in Meltzer, 2010, Book 1, 676. Emphasis added.)

Volcker left the Belgrade meeting to begin the policy change that would lower inflation by 1982. He had made the decision to let the market determine the funds rate, and he explained the decision to two administration officials on the trip to Belgrade. The political constraints that Burns emphasized had much less force for two reasons. First, Volcker believed inflation was costly. He rejected the Phillips curve model because inflation and the unemployment rate rose together, contrary to the model. From his experience on the FOMC he knew that it would be difficult, probably impossible to raise the funds rate high enough soon enough by FOMC action. Second, for the first time in the 1970s, the public told opinion pollsters that inflation was the most important domestic problem. President Carter and key members of the two banking committees supported the policy change. The president and many members of Congress faced the 1980 election in which inflation was certain to be a major issue.

After interest rates rose, labor union leaders and some members of Congress urged President Carter to use credit controls instead of higher interest rates. Existing law gave the president authority to request the Federal Reserve to control credit. Most of the president's economic advisers opposed his decision. The decision was made for political reasons, to provide an alternative to high interest rates. (Burns, 2002, 247) In a televised address to the nation, he announced spending reductions and called on the Federal Reserve to control credit. Volcker had participated in the meetings leading up to the president's announcement. He did not want to use credit controls but he, and all but one Board member, voted to accede to the president's request. The governors decided to make a modest effort.

The public's response surprised everyone. Although the new regulations did not restrict the use of credit cards, people cut their cards and mailed them to the administration and the Federal Reserve. Businesses cancelled loans. In the second quarter, aggregate demand fell more than in any quarter up to that time. The public signaled they wanted lower inflation. They sent the same signal in the fall by electing Ronald Reagan who promised to reduce inflation and restore economic growth.

Credit controls ended in the summer and money growth rose. The Federal Reserve had to restart its anti-inflation policy in the fall of 1980. To his credit, President Carter did not interfere again. After January 1981, President Reagan supported the anti-inflation policy.

History provides many additional instances of political influence on Federal Reserve policy. Recent history is perhaps two well-known to require comment. The Federal Reserve has undertaken fiscal actions, lending to AIG, investment banks and others. Perhaps one example will suffice. Interested economists can find many examples in my Federal Reserve history books.

In 1932, Congressional leaders urged the Federal Reserve Board to assist housing and the mortgage market, then as now in dire straits. The Board declined, saying that housing was not its responsibility. Congress responded with a fiscal solution by authorizing the Federal Home Loan Banks. In contrast, the current Board has undertaken large fiscal policy actions. On January 21, 2010, 42 percent of the Federal Reserve's assets were for mortgage backed securities guaranteed by Fannie Mae and other government housing lenders. Nearly 4 percent more consisted of loans to AIG or special Maiden Lane facilities. The mortgage backed securities had an average maturity in excess of 10 years. No central bank in developed countries has held so much illiquid long-term debt.

I have not mentioned international policy. Abandoning the gold standard was a political decision. Moving responsibility for international economic policy from the New York bank to the Board was a political decision, Senator Carter Glass's punishment for promising a loan to the Bank of England after England returned to the gold standard was also a political decision. And the mistaken and unsuccessful policy to produce SDRs instead of revaluing exchange rates was a political decision.

Conclusion

Federal Reserve governors are appointed to 14 year non-renewable terms to reduce political influence. The Federal Reserve is said to be independent to protect it from pressure to finance the government's borrowing. Like many other regulations, protection is circumvented. The Federal Reserve lends very small amounts directly to the Treasury, but it "warehouses" loans for foreign exchange intervention and purchases Treasury debt in the open market. In the current crisis, it has undertaken substantial fiscal actions, unlike any actions in its more than ninety-five year history.

Congress granted Federal Reserve independence under the gold standard. That imposed restrictions on Federal Reserve actions. Once the gold standard ended, those restrictions ended. Congress or an administration can get a compliant Federal Reserve to accommodate to political pressure. The historical examples cited here are a small part of a large sample.

Pressures on the Federal Reserve in the post war years have varied. Presidents Eisenhower, Ford, Reagan and Clinton did not interfere. President Kennedy repeatedly urged the Federal Reserve to "twist the yield curve" and wanted to trade some inflation for lower unemployment. Presidents Johnson and Nixon interfered most until the current administration.

History does not offer evidence of the government seeking to optimize policy in the interests of consumer welfare. Much of my Federal Reserve history is about the Great Inflation, 1964-82, the Great Depression, 1929-41, or wartime finance. Periods of low inflation and low unemployment are rare. The years 1923 to 1929, 1953-63, and the recent great moderation exhaust the years of sustained economic growth with low inflation. Political intervention, analytic error, excessive concern for near-term events, and forecast errors are main reasons.

One can look through the records of FOMC meetings without finding any discussion by members of the longer-term consequences of policy actions. Of course, Boards staff forecasts include forecasts of longer-term outcomes, but the Reserve banks use different models. There is no evidence of an effort to reconcile differences in the 73 years to 1986 covered in my history. Further, discussion of forecast differences are so rare as to be non-existent. Perhaps this changed after 1986. I conjecture that excessive concern for the near-term and neglect of the longer term reflects perceived political pressures on policy to respond to current events. I have not produced evidence for that conjecture, but I cannot think of another reason why the Federal Reserve acts that way repeatedly.

Washington has many so-called independent agencies. They are removed from politics by making fixed term appointments of members and allowing many decisions to be made without Congressional or administration interference. A small number, like the Federal Reserve finance operations without Congressional appropriations. Congressman Patman tried several times to make the Federal Reserve subject to a congressionally approved budget.

In periods of stress and public discomfort, Congress, the administration or both offer the Federal Reserve and others increased scrutiny and direction. The Great Depression resolved the long dispute about the locus of power in the system by choosing the Board, more responsive to political pressure than the banks. The Great Inflation brought Humphrey Hawkins hearings, closer monitoring, legislation restructuring directors of Reserve banks, and the release of FOMC minutes. The current crisis has not produced legislation at this time, but there are active proposals. One of them would allow the Government Accounting Office to audit open market decisions. Others review proposals to reduce the role of the reserve banks and reduce or eliminate regulatory responsibility.

These and many other changes show that the Federal Reserve officials face political constraints. The constraints can be reduced by agreeing on a rule, or quasi-rule, with Congress. The Federal Reserve has the authority to create inflation or recession, but the public blames its elected officials for outcomes they do not like. Years ago I proposed that the Federal Reserve should announce the inflation and unemployment rate they expect to achieve in the medium-term. If they failed to reach their stated goals, they could offer an explanation along with an offer to resign. Congress could accept the explanation or the resignation. Authority and responsibility would be brought closer together.

In 1988, I met with officials at the Reserve Bank of New Zealand and made my proposal. They improved on it by setting an inflation target with the political authorities and offering an explanation for target misses along with an offer to resign. Other countries have followed. Policy targets are chosen with political officials in all these countries and others. That does not eliminate political influence; it constrains it.

It is rare, even unusual, to find political pressures mentioned in FOMC records. But it would be no less surprising if they were totally absent from the minds of the members. The Board and the FOMC sit in political Washington. Presidents and members of Congress have to seek re-election when unemployment, inflation, or financial fragility are prominent issues. The Federal Reserve cannot and does not ignore the pressures. Its best protection is a rule, or quasi-rule, that Congress accepts.

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