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MONETIZATION PRACTICES AND THE POLITICAL STRUCTURE OF THE FEDERAL RESERVE SYSTEM

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Summary

Since the late 1960s the Federal Reserve Board has expanded the growth of money stocks at generally increasing rates. These policies have led to increasing inflation. The key elements in the Fed's failure to chart a noninflationary course are (1) its political composition and (2) its preoccupation with the interest-rate structure. Because Fed terms are so long, no President can exercise significant control over this major determinant of economic policy. The Depository Institutions Deregulation and Money Control Act of 1980 extended the Fed's control over commercial banks and monetization of debt. Congress must deal with the inability of the Federal Reserve System to function as intended. It could assume direct control over monetary growth, or it could bring central banking functions under the control of the President. A final option, and a true institutional reform, would begin with the abolition of the Fed as a policy-making central bank. This would allow the banking system to become competitive and thus innovative and in all likelihood serve consumers better than the Fed has done.

The Original Federal Reserve System

The title section of the Federal Reserve Act passed by Congress in December 1913 declares that the purposes of the new institution are "to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective

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supervision of banking in the United States, and for other purposes." This Act created the Federal Reserve System, commonly known as the central bank of the United States.

Several characteristics of the original Act as it passed Congress deserve emphasis. First, all of the principal sponsors of the bill declared adamantly that the new institution was not a central bank. It was, they held, a system of regional reserve-holding banks -- more or less super-commercial banks -- that would do nothing more than provide seasonal adjustments of reserves for the member commercial banks. Furthermore, it would act primarily on the initiative of the member banks, not on its own assessment of what the banking system needed. The Act was an insurance scheme: the Federal Reserve Banks were to be operational only sporadically and randomly, when unforeseen and unmanageable pressures developed on commercial bank reserves. It was to take over from the U.S. Treasury Department the monetary functions the Treasury had assumed without authorization from Congress, and it was to carry out these functions on a basis at once more scientific and less political.

This summary of the policy provisions in the orginal Federal Reserve Act gives the impression that the System was created to do almost nothing. But that is, of course, the nature of an insurance scheme.

The dominant monetary institution in 1913 was the gold standard system. The Currency Act of 1900, which declared gold to be the only legal tender, was the basic operational law for the monetary system. The gold standard was self-regulatory: If not enough gold entered the economy to serve as a basis for an increase in common money, prices fell and the real price of gold rose. By this means, exports of goods and services increased, while gold discovery and exploitation were encouraged. As these changes occurred, more gold entered the monetary system, giving rise to an increased volume of conventional money (paper currency and bank deposits), and the fall of prices was thereby arrested.

The sponsors of the Federal Reserve System did not anticipate a change in this basic institution. One of the last provisions inserted in the bill as it passed the House declared, "Nothing in this act...shall be considered to repeal the parity provisions contained in [the Currency Act] approved March 14, 1900." This statement was inserted as a precaution to affirm the priority of the gold standard in determining the general direction of the money supply. The Federal Reserve System was not to serve as a substitute for the gold standard. It was simply to operate as a self-regulating appendage to a basic mechanism that was already self-regulating.

Monetization of Gold and Other Things

Any monetary institution has power to monetize. A gold standard, for example, provides for the legal monetization of gold. It specifies that a given weight of gold is vested with the ability to clear a debt of given monetary value. Before gold is declared the standard, it may serve as money by common acceptance of the fact that it is the commodity most suited for monetary usage. Until it becomes money, either by government fiat or by common practice, it is just another commodity having utility only in its ability to fill teeth, garnish baser metals, and sanctify matrimonial contracts.

A society interested in economizing resources may also economize its monetary gold by allowing other institutions (banks) to create money. This sanction must always be constrained by the principle that these other money-creating institutions redeem with gold the common money they create. If the banks then want to endure as cost-recovering enterprises, they have every incentive to limit their money-creating activities sufficiently in such a way that gold redemption is not jeopardized.

Government creations of legal tender paper money must be similarly constrained. For if nongold moneys are not redeemable in gold on specified terms, the gold standard is not an operational reality. This argument is to guard against the terms "backing" or "backed by." If common money is not redeemable in gold, it matters not how much gold is stored somewhere in a Treasury vault that allegedly "backs" the money. For gold to "back" common money effectively, the redemption principle must be active, viable, and practicable.

The Federal Reserve Act added an additional element of monetization to the gold standard. It permitted the Federal Reserve Banks to monetize loans that they made to member commercial banks. This "privilege" was surrounded with apparent safeguards. First, the loans were supposed to be made on the basis of "eligible" paper -- that is, on advances, bills, and discounts arising from private production and marketing of real goods. Federal Reserve Bank managers were to decide if applications for loans satisfied the eligibility requirements. Second, the discount rate charged by the Fed banks was to be a penalty rate to prevent the discounting privilege from becoming a subsidy. Third, the Fed banks were themselves to face statutory gold reserve requirements, so that they too were constrained by the principle of gold redemption for the money they issued.

Enlargement of Federal Reserve Powers

The Congress that created the Fed believed that the "guidance of human wisdom" through a central bank would improve the ability of the monetary system to furnish the right amount of money to the economy at the right time. When this expectation was not fulfilled in the 1930s, the Fed's powers were further enlarged by the Banking Act of 1935.(1) This Act formalized the power of the Fed to create money by purchasing government securities, and it added the authority that permitted the Fed to specify within limits the reserve requirements for the "member" commercial banks that belonged to the Federal Reserve System. (Nonmember banks were similarly regulated by the state agencies.) The provisions of this Act, therefore, enlarged the monetization powers of the Fed to include all outstanding U.S. government securities. An act passed in 1933 prohibited all monetary transactions in gold and all private gold holdings beyond a certain minimal amount. The revised Federal Reserve System was then enthroned as a surrogate for the gold standard, and the gold standard was effectively deposed -- in spite of the precautionary hedge against this possibility inserted in the original Federal Reserve Act only twenty years earlier.

Technical Structure of the Federal Reserve System

From 1935 to the present, the decision-making structure of the Fed has been the Federal Open Market Committee (FOMC). This body is composed of the Federal Reserve Board of seven members, and five of the twelve Federal Reserve Bank presidents. Members of the board, which is based in Washington, are appointed for fourteen-year terms by the President of the United States. So that no single President could unduly bias the board or influence its operations to his own personal political advantage, the terms of the board members were staggered so that a vacancy occurred only every other year. Resignations and deaths ordinarily increase the frequency of appointments, but this contingency cannot be counted on. For most of the term of a one-term President, therefore, monetary policy may well reflect the monetary norms of his predecessors.

The presidents of eleven of the twelve Federal Reserve Banks take turns being on the FOMC. (The president of the Federal Reserve Bank of New York is a permanent member, similar to the seven board members). Unlike the board members, the reserve bank presidents are elected to office by their boards of directors. They reach their office by working their way up through the officer staffs of the reserve bank organizations.

The principal difference between presidents of reserve banks and board members is that the former are essentially heads

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(1) For an exhaustive and highly interesting account of the Fed's performance in this period, see Milton Friedman and Anna Schwartz, Monetary History of the United States (Princeton, N.J.: Princeton University Press, 1963), pp. 299-407. See also, Murray N. Rothbard, America's Great Depression (Kansas City: Sheed and Ward, 1975).

of quasi-business organizations and not constantly involved or concerned with monetary policy. The latter are chosen to carry out policy and have little or no organizational responsibilities. If anything, their other responsibilities are policy-political -- appearing before congressional committees, bankers' groups, and professional organizations. This functional difference means in practice that the board generally defines monetary policy in the FOMC, and the bank presidents go along with the "expertise" of the board. It also reflects the fact that monetary policy is centered in Washington -- contrary to the intent of the Federal Reserve Act, which saw each reserve bank acting independently within its own district.

Federal Reserve Monetization Policies from 1940 to the Present

Monetization of government securities by the Fed proceeded at a rapid pace during World War II. The primary concern of the Fed was to ensure the financing of wartime fiscal deficits at low interest rates. The policy put a constraint on the Fed's conventional objectives, but after a jurisdictional battle between the Fed and the Treasury in the late 1940s a modus operandi was imposed by a resolution from Congress in 1951. This pact, labeled "The Accord," attempted to prescribe monetary control for the Fed and to confine Treasury operations to the fiscal sector.

The 1950s witnessed little in the way of an activist monetary policy. The Fed gradually reduced reserve requirements for member banks but did little else with its monetization powers.

The late 1950s and early 1960s saw a resurgence of world trade, one effect of which was an outflow of gold from the United States to foreign central banks and treasuries at a rate of approximately $1 billion a year. The Fed effectively sterilized the loss of gold by matching the losses in the titles to gold (gold certificates) with acquisitions of government securities. The U.S. money stock, therefore, did not decline in the classical fashion. The gold standard was not allowed to operate.

The loss of gold, offset as it was by the purchase and monetization of government securities, nonetheless generated a legal accounting problem: As the title to the gold disappeared from the asset portfolio of the Federal Reserve Banks' balance sheets, with no corresponding reductions in the liability accounts, the gold reserve ratio fell to the statutory minimum. The Johnson administration and Congress met this "crisis" by abolishing the requirement -- in 1966 against bank reserve accounts at the Fed and in 1968 against federal reserve notes. These changes emphasized the powerful control over the monetary system that the Fed has assumed or been granted.

Severing the monetary system's last links with gold was an indulgence to the Fed that proved disastrous for the economy. Without this gold constraint, weak as it was, the Fed from the late 1960s up to the present expanded the growth of money stocks at rates far greater than any possible growth in real output would warrant. Furthermore, the rates have increased during this period. They began at 3 or 4 percent in the mid-1960s, surged up around 8 percent in 1968, down to 3 to 6 percent between 1969 and 1971, up to double-digit values in 1972-73, back down to around 6 percent in 1975-76, and then up to around 8 and 9 percent between 1977 and 1981.

The President's Power to Appoint Members to the Board of Governors

Federal Reserve officials have offered that rationalization that special circumstances, such as OPEC cartelization of oil prices, and institutional factors, such as lagged accounting procedures,have made control over the monetary system difficult if not impossible. In fact, the Federal Reserve does not monetize oil. Primarily, it monetizes government securities. Although real oil prices increased (but not until early 1971, if 1967 prices are taken as the base), they are just one part of the relative price spectrum. If they had increased in the absence of general price inflation, some (or many) other money prices would have fallen in accord with the compensation principle that is intrinsic in the market system.

These events are not the critical factors in the failure of the Fed to steer the monetary system on a noninflationary course. The key elements are (1) the Fed's political composition and (2) its preoccupation with the interest-rate structure.

The political problem can be seen in a table showing the dates of appointment and termination of current board members and the number of years left in the term of each member.

Table 1

Federal Reserve Board Members, Dates of Appointment and Termination, and Number of Years to Termination from July 1, 1981

Name	Appointed	Termination	Remaining Tenure (July 1, 1981)
Paul Volcker, Chairman	1979	1992*	11
Frederick Schultz, Vice-chairman	1979	1982	1
Henry Wallich	1974	1988	7
Charles Partee	1976	1986	5
Nancy Teeters	1978	1984	3
Emmett Rice	1979	1990	9
Lyle Gramley	1980	1994	13

*Mr. Volcker's term as chairman runs only to 1983.

This table shows, first, that the average term of the people on the present board is three years longer than the term of the President of the United States. Second, as a result of a number of resignations in the late 1970s, five out of the seven current members were appointed by President Carter. Third, only two vacancies will occur naturally during the four years of President Reagan's administration, and the second of these two not until 1984. Throughout its effective political life, the Reagan administration will have to live with monetary policies that reflect the ideologies of a board appointed by the man Reagan defeated for the presidency.

The present board has fostered and retained monetary patterns of substantial inflation. The monetary ideologies of the people who compose the board is antimonetarist and heavily weighted toward interest-rate control. At the same time, the Reagan administration is committed to a monetarist antiinflationary program -- one that cannot possibly succeed in the presence of an interest-rate-directed monetary policy. Can anyone imagine that such a politically intolerable situation would be allowed to exist in the State Department or any other policy-making agency of the government?

The resignations that gave rise to the Carter appointments may, of course, occur again. Reagan could then appoint people more compatible with his overall economic program. Such a "solution," however, seems unlikely at this point, and even so would still leave the institutional problem unchanged. A board as important as the Federal Reserve Board should not have its design left to chance.

Another possibility is that the board will adapt itself to the prevailing political ideology. Although this behavior has been observed in the past, it is not a solution to the problem of ensuring that the Federal Reserve System gear its policies synchronously with the general economic policies of the administration. If the office of the President is to have the power of appointing members to the Board of Governors, nothing is gained by a lagged appointment schedule that allows a given President's policies to be implemented only after he is out of office, if at all.

The principle of "independence" was incorporated in the Federal Reserve structure because the powers of the Fed were strictly limited. The Fed was not created to be the monetary equivalent of the State Department that it has since become. The whole character of the institution has changed radically; it is now the exclusive monetary institution for determining the quantity of money the economy will have. Congress must either structure it so that its policies are compatible with the prevailing political consensus or provide monetary growth-rate rules for it to follow explicitly. In fact, these options are not alternatives. Congress could very well specify a pattern of growth rates for the monetary aggregates, and at the same time change the tenure of board members so that a given President could appoint the people he thought would do the best job in carrying out the rules prescribed by Congress. Monetary policy would then be on the same footing as other governmental policies.

The Depository Institutions Deregulation and Monetary Control Act of 1980

Congress's most recent attempt to deal with central bank policy is the Depository Institutions Deregulation and Monetary Control Act of 1980. Unaccountably, this Act, hailed as the most significant banking legislation since the passage of the Federal Reserve Act, does not deal at all with the institutional framework within which monetary control is practiced. All of the Fed's structural infelicities and incompatibilities are left as they are.

The Act has two principal titles. The first extends the Federal Reserve Board's authority to impose reserve requirements over all institutions that create checkable deposits. It thus preempts separate state-agency control over such deposits in state-chartered institutions. (The constitutionality of this provision might be challenged in the courts.) The board is also given other reserve regulatory powers. The "Control" section has the effect of bringing not only the entire commercial banking system but also almost all other financial institutions under the regulatory control of the Federal Reserve Board. Naturally, if these institutions are now quasi-members of the system, they must also be granted the privilege of discounting at the Fed's "discount window." So, instead of getting rid of the anachronistic policy of central bank discounting -- a practice that started out as an insurance scheme to prevent bank panics and has since become one that subsidizes member banks with lower-than-market rates for borrowing -- the practice is extended to most of the financial community.

Appropriate to this expansion of central bank activity is the provision that extends the "eligible" paper doctrine -- prescribing the collateral on which Federal Reserve notes can be issued -- to include obligations of foreign governments or <u>agencies</u> of foreign governments. Originally (until 1932), not even U.S. government securities were eligible. Now the obligation of any foreign government may indirectly be monetized.

This provision does not change the infinitely powerful control over the monetary system that the Fed already possesses. It does, however, have interesting implications. Suppose, for example, that a prominent bank in New York, say the Chase Manhattan, had in its portfolio of earning assets some securities of dubious value issued by a Third World government and that these securities were presented as collateral for a loan applied for by Chase Manahattan to the Federal Reserve Bank of New York. Chase Manahattan administrators might argue that such a loan is vital to the existence of the bank and to the banking industry domino that might topple if Chase Manhattan went under. Whatever the persuasion, the Federal Reserve Bank of New York could effectively convert into money the defunct securities of a Third World government without consulting either a congressional body or the President of the United States.

The Fed's power to monetize is also extended to the securities of domestic corporations, e.g., to those of Chrysler or Lockheed. Any defaulted, near-bankrupt country or corporation can be brought back to life by the Fed's injections of new money. As prices rise, the taxpayer would pay the real costs of such a policy by the reduction in the purchasing power of his money. But as a taxpayer-citizen-voter he would not have chosen to finance such deficit organizations, and his elected representatives to government would not have had the chance to pass on such actions either. The Federal Reserve Board is not popularly elected.

Title II of the new act -- "Depository Institutions Deregulation Act of 1980" -- does provide for some deregulation, but it is all in the private sector. It calls for a phase-out over a six-year period of interest rate ceilings "on the maximum rates of interest and dividends that may be paid on deposits and accounts by depository institutions." The restrictions on free-market interest rates that took six seconds to impose require six years to abolish. This change is virtually mandated by the fact that many non-bank financial institutions, which pay interest on their liabilities, now are allowed to let these liabilities function as money. Elimination of interest-rate ceilings and interest-rate prohibitions against commercial bank demand deposits is therefore necessary so that competition among all financial institutions may proceed on equitable terms.

This change is well advised. It is a move toward deregulating an activity that never should have been regulated in the first place. However, it does not diminish in any marked degree the regulatory control that the Federal Reserve System has over the monetary and banking sector. It only allows the private financial sector to compete on less restricted terms. The overall regulatory controls by the Federal Reserve Board are greater than ever.

Evolution of a Miscast Government Agency

The history of the Federal Reserve is typical of a government regulatory bureau. First, a minor social problem is perceived -- in this case, occasional, extraordinary, seasonal demands for currency. Second, Congress creates an agency that has limited authority to deal with the problem -- the early Federal Reserve System. Next, the new agency assumes on its own functions that were never intended within the authority delegated to it by Congress -- open-market operations in government securities. Fourth, it fails to function properly and as expected at a critical time, and turns a minor problem into a world catastrophe -- the Great Depression of the early 1930s. Fifth, pleading lack of sufficient control while denying its own incompetence and misdirection, it secures greatly enlarged powers from Congress -- the Banking Act of 1935. Sixth, when its policies subsequently show greater vacillation, uncertainty, and political influence -- the inflation from 1966 to 1980, it gets a further grant of power from Congress -- the Depository Institutions Deregulation and Monetary Control Act of 1980.

Can it ever occur to Congress that this policy of delegating greater and greater discretionary powers to a regulatory agency is a blueprint for disaster? Is it impossible for Congress to recall that monetary behavior without a central bank, while not perfect, was much more stable, predictable, and productive than monetary policy under the discretion of a central bank?

Congress should deal candidly with the inability of the system to function as intended. One option that could be pursued is drastic limitation of the power of the Board of Governors (and of the larger Federal Open Market Committee) to control the monetary system. Congress, by its constitutional authority "to coin money and regulate the value thereof," has the duty of specifying rigorously the growth rate in the monetary base -- the explicit accountable variable over which the Federal Reserve System has complete technical control. Another option is for Congress to bring central banking functions under the authority of the executive branch so that monetary policy can be made compatible with a given administration's general economic policy. Either change would greatly improve the present institutional structure, which allows the central bank unlimited monetary powers with no corresponding accountability for its actions.

Elimination of the Federal Reserve System

A final option, and a true institutional reform, would begin with the abolition of the Federal Reserve System as a policy-making central bank. The primary technical functions of Federal Reserve Banks are the clearing of checks, the accounting of member banks' balance sheets, and the administration of the currency. In addition, the Fed banks include legal departments that are almost entirely concerned with the entry, exit, and existence of commercial banks. How would the monetary system provide these functions for itself without the Federal Reserve System? Certainly, the entry and exit regulation of commercial banks could be disposed of immediately. Banks have no more reason to be regulated than grocery stores. They should be left alone to justify their existence in a free-market system by means of the functions they perform.

The technical check-clearing operations of the Federal Reserve Banks could still be handled by the existing physical facilities. Federal Reserve Banks could be reorganized as regional bank clearing houses. Since the Fed banks are already legally owned by commercial banks that exercise no control or ownership, the solution is simple: Turn the Federal Reserve Banks over to the legitimate owners and let the member banks operate them. It does not take a genius to manage a clearing-house. This change would probably witness many interesting innovations and economies in bank management and checking facilities.

The final issue deals with the decision-making policy functions of the Fed. There is no need to spend any time at all on reserve requirements or discounting for member banks. At worst, the elimination of reserve requirements would only throw this particular regulation back to the states. Illinois has no reserve requirements of any sort, so this constraint is already seen to be completely unnecessary. The banks can manage their own reserve necessities.(2) The discounting function is both unnecessary and undesirable. It is a very small factor in the Fed's total monetization program. Most banks borrow needed reserves from, and lend excess reserves to, each other in a well-organized private market, the Fed funds market. The end of federal reserve discounting, therefore, would simply end something that is largely an advertising gimmick for promoting the image of the Fed as a bankers' welfare agency.

What would take the place of open-market operations and the monetization of government securities, the process that keeps the money stock burgeoning at inflationary rates?

The answer to this question includes a golden opportunity. The U.S. Treasury holds about 260 million ounces of gold, which it obtained in the 1930s on the basis of a law of questionable constitutionality. This inactive stock has no utility for anyone and requires real resources for its custody. Let this gold be sold off or distributed pro rata to every U.S. citizen -- approximately 1.12 ounces per person -- either in the form of coin or in certificates redeemable in coin. At the same time abolish the policy-making structure of the Federal Reserve System -- most notably, the Board of Governors and its allied

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(2) No other system in the world employs reserve requirement laws to regulate commercial banks.

bureaus in Washington. Finally, freeze the outstanding volume of federal reserve notes, the legal tender paper currency in general use today, and convert all member bank reserve accounts at Federal Reserve Banks into federal reserve notes that the commercial banks would hold in their own vaults or own as deposits in their "new" clearing houses. The new gold, liberated from government custody, would be deposited in banks and would give rise to gold-based deposits that would require redemption in gold (or Federal Reserve notes at the option of the depositor). This new system would not be a gold standard because the government would not declare gold or anything else legal tender. The existing legal tender federal reserve notes would be left as is in the system because the harm they do has already been done; and to recall and retire them would have unnecessary and undesirable side effects. Gold-based deposits and currency would circulate side by side with the frozen stock of existing federal reserve notes. Prices of gold in terms of other moneys would be quickly determined by market factors. The banking industry would become competitive and, therefore, innovative. Most notably, the great uncertainties in economic life caused by the current on-again, off-again policies of the Federal Reserve Open Market Committee would disappear. Prices would stabilize. The monetary system would become good if not perfect. It would produce good money for the same reason that a shoe industry or an electronics industry produces good shoes and good calculators: because the self-interests and profits of both consumers and producers of these products are maximized when the items produced are of good quality. We could hardly expect less from a private enterprise monetary system.

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