



Cooperation, Conflict, and the Emergence of a Modern Federal Reserve

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The Federal Reserve System is a model of an independent central bank, with the authority to resist political pressure and act in the long-term best economic interest of the country. But this has not always been the case. In the past—and not too distant past at that—US monetary policy has frequently yielded to other governmental requirements. Even for the modern Federal Reserve, independence is a nuanced, mutable and, ultimately, fragile concept, but one that is essential to maintain.

The hallmark of a modern central bank is its ability to conduct monetary policy independent of direct political influence. Without independence, a central bank's promise to deliver long-term price stability never seems entirely airtight, and markets react accordingly. The Federal Reserve System is unquestionably a modern central bank for which political pressures seem faint, but this has not always been the norm. In the past, US monetary policy has frequently yielded to other governmental requirements.


This acquiescence is not entirely surprising; the very notion of central-bank independence contains an intrinsic tension. Central banks are ultimately accountable for their actions to the governments that created them, and these governments sometimes have monetary objectives that take precedence over price stability. Because of this tension, central-bank independence is a nuanced, mutable and, ultimately, fragile concept—as the Federal Reserve's not-too-distant past illustrates.

This *Economic Commentary* recounts the Federal Reserve's struggle for independence after the Second World War, showing that the famous Treasury–Federal Reserve accord in 1951 did not make the Federal Reserve entirely “modern.” Subsequent tensions only became more subtle. In a world where the unconventional in monetary policy now has standing, where governmental debt-burdens are high, and where global policy spillovers raise calls for reform, it is a story worth retelling.

Forgoing Independence in War

During the Second World War, the Federal Reserve effectively abdicated its responsibility for monetary policy, despite a concern about wartime inflation, and focused instead on helping the US Treasury to finance the conflict. The Federal Reserve's contribution consisted primarily of maintaining a fixed yield curve, which was both relatively low and inordinately steep. The low yields minimized the Treasury's borrowing costs, as gross federal debt grew from 42 percent of GDP in 1938 to an all-time record of 122 percent of GDP in 1946. The firmly harnessed rate structure minimized the risk of capital losses from holding longer-term securities, but the entire approach ended the Federal Reserve's monetary independence.

In March 1942, the Federal Reserve pegged the Treasury bill rate at 0.375 percent, implying that the Federal Reserve would freely buy or sell Treasury bills on demand with investors at that rate. In addition, the Federal Reserve capped the yields on all other Treasury securities—most importantly, a 2.5 percent limit on long-term Treasury-bond yields. Limiting these yields required the Federal Reserve to buy all securities that the public did not wish to hold when yields reached their ceilings. The limit on the long-term bond yields, although low, was not too far out of line with recent experience, but the rate caps on the shorter end of the yield curve remained extremely low from a historical perspective. In any event, the yield curve was exceptionally steep.



With the yield curve fixed, long-term securities were virtually as liquid as short-term securities. By 1943, investors—notably banks—began shifting into the higher yielding long-term Treasury bonds. To maintain its peg on Treasury bill yields, the Federal Reserve acquired \$10 billion of the securities, or 65 percent of all Treasury bills issued between March 1942 and August 1945. The Fed also bought nearly \$3.4 billion in relatively short-term Treasury certificates over the same period. Initially, the Federal Reserve also acquired a considerable amount of long-term Treasury bonds, but after 1942, private demand for these instruments remained so strong that the Federal Reserve actually reduced its holdings of them.

Altogether, the Fed acquired \$20.3 billion in Treasury securities during the war, and like normal open-market operations, these security purchases injected reserves into the banking system. Unlike normal open-market operations, however, the Treasury could—and did—force the reserve creation by selling additional Treasury bills into the market, which investors then sold to the Federal Reserve and bought longer-term issues. The Federal Reserve's monetary independence was gone. On average over 1943, 1944, and 1945, money growth exceeded real output growth by 9.7 percent, indicating that the Federal Reserve's purchases of Treasury securities offered a significant impetus to inflation. With monetary operations aimed solely at debt-management goals, the Federal Reserve and the administration attempted to contain the symptoms of inflation through credit restraints and wage-and-price controls.

Regaining Monetary Authority

The Federal Reserve accepted its role in wartime finance, but as the war ended it sought more flexibility in its operations. At first, this only meant that the Federal Open Market Committee (FOMC) wanted the Treasury to set more realistic security prices and to allow short-term yields to rise somewhat. Market rates of similar maturity had already begun to rise. The Treasury, concerned about refunding operations, resisted. With monetary policy still in abeyance, the money supply grew 23 percent faster than real output in 1946. Predictably, with price controls now gone, inflation quickly reached double-digit levels and eventually peaked at nearly 20 percent (year-over-year) in May 1947.

In that year, the Federal Reserve began taking tentative steps toward reasserting its authority over monetary policy, but its subservience to the Treasury would continue for another five years. With the Treasury's endorsement, the Federal Reserve stopped pegging the yield on Treasury bills in July 1947 and ended its ceiling on Treasury certificates a month later. The Treasury, however, maintained considerable leverage over the Federal Reserve, even in the bills market, because the Treasury set coupon yields on other securities, which the Federal Reserve felt compelled to maintain at, or above, par. If the Federal Reserve failed to do so, a debt operation might fail, and Congress or the administration

might blame the Fed. Eventually, the Federal Reserve and the Treasury agreed to a series of increases in the bill rate, which reached 1 percent by early 1948. They also agreed to loosen yield ceilings on other instruments, except long-term Treasury bonds. Both the Federal Reserve and the Treasury thought that maintaining the ceiling on long-term Treasuries was vital, even if doing so constrained monetary policy. Higher yields on long-term Treasuries would raise the cost of Treasury debt and could risk capital losses, all of which might damage the market for Treasury securities.

As short-term rates rose a bit, individuals and banks began to liquidate their holdings of long-term securities while the Treasury was still selling substantial amounts of them. Long-term yields began to rise, requiring the Federal Reserve to enforce its yield cap after October 1947 by buying long-term Treasuries. Over the next 12 months, the Federal Reserve added nearly \$10.5 billion of long-term Treasury bonds to its portfolio. In an attempt to offset the inflationary impact of these purchases, the Federal Reserve sold nearly an equal amount of short-term securities, but such offsets could not continue indefinitely. The Federal Reserve's stock of short-term assets was finite.

In 1948, the Federal Reserve attempted to flex its long-atrophied monetary muscle a bit more by raising the discount rate and hiking reserve requirements. The Treasury allowed the yields on Treasury certificates and bills to rise further but in return asked the Federal Reserve to reaffirm its commitment to a 2.5 percent ceiling on Treasury bond yields and to refrain from further increasing reserve requirements.

The cooperative air was turning fetid by 1949, as the economy slipped into recession and prices generally fell. The Federal Reserve cautiously—and reluctantly—cut interest rates. It feared that the Treasury might lock in lower rates and compel the Federal Reserve to support them as the economy eventually recovered. When the Federal Reserve asked the Treasury to postpone announcing low coupon rates on new issues, the Treasury refused. As its refusal demonstrated, the Treasury continued to control monetary policy.

The outbreak of the Korean War in June 1950 caused a surge in speculative buying and aroused the Federal Reserve's fear of inflation, which would reach 9.4 percent by February 1951. Before announcing a unilateral decision to raise the discount rate and short-term rates, the Fed chairman and the president of the Federal Reserve Bank of New York met with the Treasury secretary and asked for his cooperation. Instead, the Treasury announced the issue of certificates at rates too low to be consistent with market expectations for yields. To prevent the operation from failing, the Federal Reserve bought all of the new issues at par, and again offset the inflationary implications by selling other short-term securities at a price consistent with the higher market yields. The Treasury consistently priced new issues too high, thereby forcing the Federal Reserve to support

the sale. By late 1950, the Federal Reserve was running low on short-term securities to sell as an offset. Consequently, the Federal Reserve's balance sheet expanded, and inflation continued to rise.

By early 1951, the conflict over monetary policy between the Treasury and the Federal Reserve was intensifying. Many—including some in Congress—now accused the Treasury of attempting to usurp the Federal Reserve's monetary authority. Prompted to intervene, President Truman invited the entire FOMC to the White House for a conference in January 1951. Subsequent reports portrayed the White House as supporting the Treasury's position and the Federal Reserve as agreeing to maintain the current yield structure for the duration of the war. In February, President Truman thanked the Federal Reserve chairman for the Fed's support.

The Federal Reserve, however, quickly released a memorandum of the meeting, showing that the FOMC had not pledged to fix the yield curve. The conflict festered through the month, but in March, the secretary of the Treasury and the Fed chairman released the following statement: "The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt." Was the Federal Reserve now modern?

Independent within, Not of, Government

After the accord, the Federal Reserve neither sought the Treasury's permission to raise interest rates nor pegged specific security prices, but the Federal Reserve continued to support the Treasury's debt-management operations. Federal Reserve Chairman William McChesney Martin famously viewed the Federal Reserve as independent within the government, not independent of the government, which, in the then-current context, meant that the Federal Reserve needed to support the Treasury's debt-management operations since these stemmed from legitimate Congressional budgetary decisions, and Congress had created the Federal Reserve. By 1955, the Federal Reserve's equivocal interpretation of independence evolved into a specific debt-management policy, known as even-keel.

The overall objective of even-keel was to avoid disorderly money-market conditions from the time that the Treasury announced a security offering until private underwriters had an opportunity to place the paper—usually about three weeks. During this time, the Federal Reserve delayed changes in monetary-policy instruments (the discount rate, reserve requirements, or overt open-market operations) and typically added some reserves to the banking system. Adding reserves insured that underwriters had adequate liquidity to finance their purchases, since the Treasury debt sales themselves

would briefly drain reserves. Some economists believe that even-keel operations contributed to the Great Inflation (1965–1982); they certainly did not help the situation.

The government's debt-management demands on monetary policy faded away by the mid-1970s as the Treasury began routinely auctioning its debt. Nevertheless, 1961 brought a new administration claim on the Federal Reserve, one that—like debt-management operations—the Federal Reserve at first warmly embraced, but ultimately viewed as a threat to monetary policy.

Subtly Persistent

The Federal Reserve's pre-accord conflicts and its even-keel episode starkly show how governmental objectives can compromise the central bank's independence and monetary policy. But sometimes this interaction is much more subtle, almost imperceptible. The Federal Reserve's foreign-exchange operations offer an example.

Between 1961 and 1995, the Federal Reserve System frequently intervened in the foreign-exchange market either to protect the US gold stock (1961–1973) or to influence exchange-rate movements (1973–1995). The Federal Reserve Bank of New York transacted in the market for both the Federal Reserve's own account and for the US Treasury's account. Although appearing as coequals, the Treasury, by virtue of its clearer legislative mandate for foreign-exchange actions, was the dominant force in US foreign-exchange operations. The Federal Reserve never transacted without the Treasury's assent and almost always participated at the Treasury's request.

Although the Federal Reserve routinely offset any unwanted impacts from intervention on bank reserves, many FOMC participants came to view intervention as exerting a slow corrosive force on the Federal Reserve's credibility, which the Fed had worked hard to secure over the Volcker-Greenspan years. In the late 1980s and the early 1990s, the FOMC began tightening monetary policy; the dollar appreciated, and the Federal Reserve—under the Treasury's direction—began selling dollars into the foreign-exchange market to stem the dollar's rise. Although the Federal Reserve prevented these actions from creating unwanted bank reserves, many FOMC participants feared that the sterilized intervention sowed confusion about the direction of monetary policy, the limits of Federal Reserve independence, and the FOMC's commitment to price stability. Some called for a second accord. After a prolonged debate, the FOMC ended its routine interventions in 1995.

So when did the Federal Reserve finally become a modern central bank—at the accord in 1951, when even-keel ended in 1975, or when routine foreign-exchange operations ended in 1995? It is not entirely clear. Perhaps the lesson to take from the Federal Reserve's experience since the Second World War is that central-bank independence is a nuanced, mutable, and fragile attribute.



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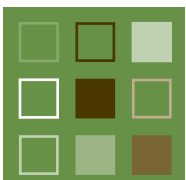
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This Economic Commentary is a short version of

“Independence within—not of—Government: The Emergence of the Federal Reserve as a Modern Central Bank,” Owen F. Humpage, 2014. Federal Reserve Bank of Cleveland, working paper no. 14-02.

That paper contains a complete set of references and figures.

On foreign-exchange intervention and monetary policy, see Strained Relations: US Foreign-Exchange Operations and Monetary Policy in the Twentieth Century. Michael D. Bordo, Owen F. Humpage, and Anna J. Schwartz, forthcoming. Chicago: Chicago University Press.



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