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The Independence of the Federal Reserve System

Address by

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of

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It is a pleasure to be here on this beautiful campus and to join the audience in honoring the graduating class of Bryant College.

In earlier and calmer times, it was customary for a commencement orator to address the principles of life that he thought would be most helpful to members of the graduating class. Such pronouncements are less fitting in our turbulent age, which has sharply narrowed the gap in knowledge -- if not also in wisdom -- that once separated the generations.

Yet each of us, and here your elders may have some advantage, has had opportunity to reflect with more than ordinary care on his own range of responsibilities. I therefore want to share with you today a few thoughts about the Federal Reserve System, which serves as our Nation's authority for controlling the supply of money and credit.

Industrial nations, including our own, nowadays rely heavily on monetary policy to promote expansion of production and employment, to limit any decline that may occur in over-all economic activity, or to blunt the forces of inflation.

There are two major reasons for the emphasis on monetary policy. In the first place, manipulation of governmental expenditures has proved to be a rather clumsy device for dealing with rapidly changing economic developments. Secondly, the process of reaching a concensus on needed tax changes usually turns out to be complex and time-consuming. Experience has thus taught us that alterations of fiscal policy, once undertaken, frequently have a large part of their economic effect too late to be of much value in moderating fluctuations in business activity.

Even when the economy is booming, legislatures are rarely willing to increase tax rates or to restrain the rising curve of governmental expenditures. Such reluctance also limits the discretionary use of fiscal measures to counter the forces of recession that develop from time to time in a free enterprise economy. Once reduced, tax rates cannot easily be increased again, and new expenditure programs to stimulate a lagging economy all too often are the source of a new inflationary problem later on.

Fortunately, monetary policy is relatively free of these shortcomings. Flexibility is the great virtue of instruments of monetary and credit policy. Changes in the course of monetary policy can be made promptly and -- if need be -- frequently.

Under our scheme of governmental organization, the Federal Reserve can make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. And experience indicates that the effects of substantial changes in the supply of money and credit are rather speedily transmitted through financial markets to the workshops of the economy -- that is, our factories, mines, construction yards, and the range of service establishments.

The founders of the Federal Reserve System were well aware of the dangers that would inhere in the creation of a monetary authority subservient to the executive branch of government -- and thus subject to political manipulation. Senator Nelson Aldrich, Chairman of the National Monetary Commission, whose investigations of central banking laid the basis for establishing the Federal Reserve System, was deeply impressed with the need for a strong monetary authority capable of exercising discipline over the financial affairs of a nation. Carter Glass, Chairman of the House Banking and Currency Committee when the Federal Reserve Act was passed in 1913, reported that the Committee regarded the Federal Reserve Board "as a distinctly nonpartisan organization whose functions are to be wholly divorced from politics." That view was fully shared by President Woodrow Wilson, who was extremely careful to avoid any suggestion of interference with the newly-created monetary authority, thereby setting a precedent that has been usually followed by succeeding Presidents.

The concept of independence of the monetary authority within the structure of government is congenial to the basic principles of our Constitution. As Alexander Hamilton put it in one of the Federalist Papers, our system of government is based on the precept that partitions between the various branches of government "ought to be so contrived as to render the one independent of the other." Such a division of power, according to another of the Federalist Papers, is "essential to the preservation of liberty."

The principle of independence of the monetary authority within the structure of our Federal Government was embodied in the original Federal Reserve Act in several ways. First, individuals appointed to the Federal Reserve Board by the President were to have 10-year terms, and they could be removed from office only for cause. A President could not, therefore, remove a Board Member from office simply because he disagreed with his views, and the term of office was long enough to minimize the threat of covert political pressure on Board Members. Moreover, the law provided for staggered terms in order to avoid Presidential "packing" of the monetary authority.

Second, the newly-created Federal Reserve Board was required to report on, and to account for, its actions to the legislative branch of government, not to the Administration.

Third, the operations of the Federal Reserve System were to be financed from its own internal sources, and thus protected from the political pressures that may be exercised through the congressional appropriations process.

Fourth, power was to be diffused within the Federal Reserve System, so that the interests of borrowers, lenders, and the general public were to be recognized and blended in the new regional Federal Reserve Banks.

In the years that followed creation of the Federal Reserve System, experience -- particularly during the Great Depression -- suggested that the degree of independence assigned to the monetary authority was insufficient. The Banking Acts of 1933 and 1935 sought to rectify this and other defects in the financial structure.

Under the new legislation, the Secretary of the Treasury and the Comptroller of the Currency, who originally were _ex officio_ members of the Board, were relieved of this responsibility. The terms of the members of the Board were lengthened from 10 years to 12 years, and then to 14 years, to insulate the Board still more from political pressures. A new agency -- the Federal Open Market Committee, including representatives of the regional Federal Reserve Banks as well as members of the Board located in Washington -- was established to conduct open-market operations, which by the early 1930's had come to play a major role in implementing monetary policy. Moreover, the principle was reaffirmed that funds used by the Federal Reserve to finance its operations were not to be construed as government funds or as appropriated monies. All of these legislative changes strengthened the ability of the Federal Reserve System to resist efforts by the Treasury, or the White House, or any other agency in the executive branch to influence unduly the course of monetary and credit policy.

Senator Carter Glass once stated that intelligent and fearless performance of the functions of the monetary authority "involves as much of sanctity and of consequence to the American people as a like discharge of duty by the Supreme Court of the

United States." We at the Federal Reserve have in fact sought to model our conduct on that of the Supreme Court.

In the exercise of our adjudicatory responsibilities, the members of the Board scrupulously avoid any contact with interested parties. In our deliberations on monetary and credit policies, not the slightest consideration is given to questions of political partisanship. Every member of the Board, and every member of the Federal Open Market Committee, weighs the issues of monetary and credit policy solely from the viewpoint of the public interest and the general welfare. My colleagues at the Federal Reserve are highly qualified individuals possessing a diversity of skills essential to the management of the nation's financial affairs. They live and work under a Spartan code that avoids political entanglement, conflicts of interest, or even the appearance of such conflicts. At the same time, the members of the Board, particularly its Chairman, maintain close contact with members of the Executive and the Congress in order to assure that the activities of the Federal Reserve are appropriately coordinated with what other branches of government are doing.

Our system of monetary management, I believe, is thus working in the way the founders of the Federal Reserve intended. Nonetheless, there are now, as there have been over the years, some well-meaning individuals in our country who believe that the authority of the Federal Reserve to make decisions about the course of monetary policy should be circumscribed. The specific proposals that have been put forth over the years differ greatly, but they usually have had one feature in common -- namely, control by the Executive Branch of government over the monetary authority.

A move in this direction would be unwise and even dangerous. It is encouraging to find that, despite occasional outbursts of temper, a majority of the Congress share this belief. I doubt that the American people would want to see the power to create money lodged in the presidency -- which may mean that it would in fact be exercised by political aides in the White House. Such a step would create a potential for political mischief or abuse on a larger scale than we have yet seen. Certainly, if the spending propensities of Federal officials were given freer rein, the inflationary tendency that weakened our economy over much of the past decade would in all likelihood be aggravated.

The need for a strong monetary authority to discipline the inflationary tendency inherent in modern economies is evident from the historical experience of the nations around the world. Among the major industrial countries, West Germany and the United States appear to have achieved the greatest success -- albeit woefully insufficient success -- in resisting inflationary pressures in the period since World War II. It is no accident that both countries have strong central banks. In some other countries, where the monetary authority is dominated by the Executive or the legislature, inflationary financial policies have brought economic chaos and even extinguished political freedom.

It is, of course, essential that the monetary authority observe the spirit as well as the letter of our laws. In our democratic society the independence of a governmental agency can never be absolute. The Federal Reserve System is thus subject not only to the provisions of the Federal Reserve Act, but also to the Employment Act and numerous other statutes. The original design of the Federal Reserve System recognized this duty by requiring the Federal Reserve to account for its stewardship to the Congress. The oversight responsibilities of the Congress for the conduct of the monetary authority do not, however, require congressional involvement in the details of implementing monetary policy. The technical complexities of adjusting monetary or credit instruments to the needs of a modern industrial economy are far too great to be dealt with by a large deliberative body. At the same time, there is a significant role for the Congress in setting forth the economic and financial objectives that the monetary authority is expected to observe and honor.

Over the past year, the Congress has been exercising its vital oversight function through a new and more systematic procedure, spelled out in House Concurrent Resolution No. 133. That resolution requires the Federal Reserve to report to the Congress at quarterly intervals on the course of monetary policy, and to project ranges of growth in the major monetary and credit aggregates for the year ahead.

We at the Federal Reserve regard the dialogue between the monetary authority and the Congress stimulated by the Concurrent Resolution as constructive. It has given the Congress a better opportunity to express its views on the appropriateness of our actions. It has also provided us at the Federal Reserve with an opportunity to explain fully the reasons for our actions, and to communicate to the Congress and to the public at large our firm intention to adhere to a course of monetary policy that is consistent not only with continued economic expansion at a satisfactory rate, but also with further gradual unwinding of inflationary tendencies.

Such a course of policy, I believe, is the only option open to us if we as a nation are to have any hope of regaining price stability and maintaining a robust economy. Our country is passing through a fateful stage in its history. Economic, social, and political trends of the past several decades have released powerful forces of inflation that threaten the vitality of our economy and the freedom of our people.

Defeating the forces of inflation requires determined action. Greater discipline is needed in our fiscal affairs, and structural reforms are required to improve the functioning of our labor and product markets. But all such reforms would come to naught in the absence of a prudent course of monetary policy. At this critical time in our history, any interference with the ability of the Federal Reserve to stick to a moderate rate of monetary expansion could have grave consequences for the economic and political future of our country.