The Fed in a

Political World*

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Anyone following the banking press at all closely will notice questions like these appearing frequently:

- Whether the Fed in the eyes of Congress is putting enough money into the economy to assure recovery.
- Whether it is proper for a Federal Reserve Bank to spend nearly $80 for cigars.
- Whether the Fed should be audited by the General Accounting Office.
- Whether appointments of Federal Reserve Bank Presidents should be confirmed by the Senate.
- Whether the Fed will push up the money supply in order to help reelect President Ford in 1976 as some people allege it did for President Nixon in 1972.

There is a strong *political* overtone to each of these questions. Yet, it is frequently said that the Fed is *nonpolitical*. Which is it? Are we political, or aren't we? A simple "yes" or "no" answer, I'm afraid, is just that—too simple. A more realistic way to phrase the question is: *how* political is the Fed and *in what sense?*

In a broad sense the Fed must be part of the political process. Politics is the art of government—in our system, representative government. Government must do what the people want; politics is the process of discovering what they want and how to get it for them.

Accordingly, the Fed must be responsive to the public. To say that it is nonpolitical—at least in this broad sense—implies that the Fed knows better than the people themselves what they should have. This is an elitist view inconsistent with our form of government.

Yet, there is something special about the Federal Reserve. It manages the money supply. A lesson in history is that sovereigns frequently have abused their power to manage money. Some years ago we published an

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analysis of this history which pointed out how Henry VIII at one time became known as Old Copper Nose.[1] The reason was that once he needed money and called in all the silver coins, and melted and recoined them with a copper base. As the new coins became worn and blotched, the most prominent part of Henry's features, his nose, protruded through the thin silver coating in a dull relief of copper—hence, Old Copper Nose. Even our own George Washington was saddled with the problem of paying his troops with paper money that declined so precipitously in value that the Continental dollar cost more to print than it was worth as money.

Given this long history of abuse, the founders of the Federal Reserve System had good reason for insulating the Fed from narrow political pressures. The Fed is non-political in this sense. Its fortunes are not tied to the reelection of any Government official. It is for this reason that any official in the Fed properly resents allegations that policy has at any time been slanted to influence elections. Having either observed or participated in meetings of the Open Market Committee for a decade and a half, I can recall not a single instance when this motivation was present either explicitly or implicitly.

There is constant tension between these two concepts—being responsive to the public in the broad sense and being insulated from narrow, short-run politics. This tension characterizes much of what happens in the Fed. It is seen in what we do and how we do it.

WHAT THE FED DOES

This is *the* biggest political issue because it is *the* most fundamental. It has to do with the kind of economy the people want. Let me make a generalization that is oversimplified but nevertheless says a lot about the environment in which the Fed operates: political liberals tend to advocate full employment policies, conservatives a stable dollar. The emphasis given to these objectives shifts over time. Last year public opinion polls indicated that inflation was the number one problem. Now it is unemployment. The Fed finds itself constantly in the middle, trying to reconcile these two views. For example, in recent Congressional hearings some experts argued for increasing money at the rate of 10 percent a year in order to reduce unemployment. Others argued that money growth should be kept considerably below this rate because of the fear of resumption of double-digit inflation.

The official Fed position is that unemployment is the short-run problem, and that we should try to facilitate recovery and bring down unemployment. Inflation, though, is the long-run problem and we must be careful not to rekindle it. Overstimulating the economy now to achieve greater success on the unemployment front is likely to produce another round of double-digit inflation later. The Fed must keep an eye on both the short and long run when making policy. I agree with this position but would feel better about it if there were stronger Government programs to deal with unemployment by other means. These include liberalized unemployment compensation and more vigorous commitments to public service jobs, more effective training, and a more enterprising minimum-income program.

The pushing and pulling between the objectives of stable prices and full employment, whatever the outcome today, will be a political struggle which will be with us for a long time. It involves value judgments on which people have strong differences.

HOW THE FED DOES IT

Dispersion of Power through Organization. Political considerations strongly influence the ways in which the Fed goes about accomplishing its objectives. They are reflected first of all in its *organization*. The Federal Reserve Act was very much the result of a

[1] "Henry VIII Revisited: The Problems and Temptations of Money Creation," *Business Review* of the Federal Reserve Bank of Philadelphia, January 1960, pp. 3-18.

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political process and the founders of the System had political considerations in mind when they hammered out the organizational framework.

Internally, the organization emphasizes dispersion of power. In this sense, the organization of the Fed parallels that of government. Heading the System is the Board of Governors—seven Governors, not one as in most other central banks—appointed by the President and confirmed by the Senate. As a further dispersion of power, the Fed has 12 semi-autonomous Banks. Each Bank has a Board of nine Directors. Three come from banking, three from the ranks of borrowers, and three (those appointed by the Board of Governors) from the public at large. The Federal Open Market Committee (which has the major responsibility for monetary policy formation) is a combination of the Board of Governors and Presidents of Federal Reserve Banks. The Federal Advisory Council is a group of bankers which advises the Board of Governors. This is a complicated mixture of different groups designed to avoid concentration of power in one person or place.

Authority over policy tools is also distributed. The Board of Governors determines reserve requirements and sets many regulations, such as Regulation Q and margin requirements. Open Market operations are governed by the Federal Open Market Committee. The discount rate is set by each Board of Directors subject to review and determination by the Board of Governors.[2]

In all these arrangements the Board of Governors has most of the power and this is as it should be, but the decentralized nature of the organization and the decision-making process provides an internal balance to this power. Although it is inevitable that power relationships will change in this kind of an administrative situation, the "dispersion principle" is so fundamental to the Fed and the national interest that power shifts over time should be back and forth rather than in one direction—offsetting instead of reinforcing.

Externally, the organization provides insulation from certain kinds of political pressure. The 14-year terms of the Governors are designed to protect them against short-term swings of partisan politics. This arrangement enables the Governors to give appropriate weight to the long-run consequences of policy decisions. Without these long terms, Governors would be subjected to political pressures to achieve short-run changes in the economy, possibly at the expense of what is best for the economy over the long haul.

In my view, this complex organization provides adequate insulation against political pressures. However, some minor modifications could be made. First, as has been proposed by several commissions in the past, the term of the Chairman of the Board of Governors could be made to coincide with that of the President of the United States. Second, shorter terms for Governors, say ten years, could be provided without much risk. Third, a couple of the provisions which Senator Proxmire has indicated he will introduce in a bill to reform the Fed could be accepted without causing any harm.[3] One of these would have the Chairman's term subject to approval of the Senate. This would enable Congress to have somewhat more control over general monetary policy. A second would require that consideration be given to candidates from consumer and labor groups when making appointments to the

[2]Reserve requirements set the amount of reserves that member banks are to hold. Regulation Q places a ceiling on all interest rates paid by member banks on time and savings deposits. Margin requirements set the cash down payment required when purchasing stock on credit. Open Market operations—the buying and selling of securities by the Fed—affect bank reserves, interest rates, and the growth of the money supply. The discount rate is the interest rate which the Fed charges member commercial banks that borrow from it.

[3]U.S., Congress, Senate, Housing and Urban Affairs Committee, *S. 2285: A Bill to Amend the Federal Reserve Act to Provide for Senate Confirmation of Certain Appointments, and for Other Purposes*, 94th Cong., 1st sess., 3 September 1975.

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Board of Governors. I don't believe this is necessary since members of the Board consider it their responsibility to look out for the concerns of these groups among others. Moreover, it would be undesirable to begin constituting the Board with members who view themselves as advocates of special interest groups. Nevertheless, I see little harm in giving "due regard" to individuals from consumer and labor interests in considering appointments.

I do see positive harm, however, in the other proposals Senator Proxmire has made. Most of all, it would be highly undesirable to have Congress make appropriations for Federal Reserve expenditures. This would involve Congress in details of Fed policy and operations which, as I'll indicate shortly, Congress should not and cannot effectively undertake. I would also oppose having appointments of Presidents of Reserve Banks subject to Senate confirmation. On the surface this appears to strengthen the hands of the Presidents in serving on the Open Market Committee, but it promises to politicize their appointments, to undermine the role of the local Board of Directors, and to open up a number of undesirable issues with regard to employment status and compensation. Finally, the provision to provide staff assistance for individual Governors is a detail which can be handled best by internal administrative arrangement.

Fed Philosophy: Free Markets versus Credit Allocation and Fine Tuning. A second way in which political considerations influence how the Fed does its job is in the *philosophy of operation*. Let me make another generalization that is somewhat oversimplified but nevertheless goes far to explain many conflicts: the Fed tends to emphasize the free market; many politicians tend to emphasize intervention in the free market and fine tuning.

This difference is seen first of all in the allocation of credit. In emphasizing the free market the Fed traditionally argues that the economy works best with least detailed intervention. The economy does need overall regulation in the sense that, as Walter Bagehot[4] said, money will not manage itself. But the Fed has considered its job simply to be one of regulating the overall supply of money and credit and leaving it to the market to allocate that credit. However, there are those who believe that the market doesn't do the job well. It allocates credit in a manner that is incompatible with their view of social priorities. For example, during periods of tight money the market allocates credit in a way that severely affects housing and small business. Yet, many individuals rank these sectors of the economy high on their lists of social priorities and seek methods of shielding them when credit is tight.

This is a matter that greatly concerns many people and it is not going to go away. It is also one for which I happen to have a good deal of sympathy. Undoubtedly, one approach is to do what we can to improve financial markets. Ceilings on interest rates, for example, limit the free flow of funds, often to the detriment of "high priority" sectors of the economy. The Hunt Commission (President's Commission on Financial Structure and Regulation) tried to get to the heart of this problem by its recommendations for sweeping changes among financial intermediaries. Improving markets is all to the good, but it is likely to happen slowly and with difficulty. Another approach is for the Federal Government to intervene in markets through fiscal action. In recent years, the formation of a number of Government mortgage agencies has been effective in helping the housing sector. Such actions are a more direct method of providing funds. The problem with them is that Government may become involved in credit markets to a greater extent than desired.

[4]This nineteenth-century English economist, political analyst, and editor, was a practically trained theorist on banking and financial matters. His *Lombard Street* (1873), written to explain the necessity of keeping a greater reserve in the hands of the Bank of England, helped formulate the modern theory of central banking.

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Finally, this leaves us with selective credit controls.[5] This is a possibility that has always had a great deal of appeal to me. Unfortunately, there is a real question as to whether such controls work. Representative Reuss's proposal to place differential reserve requirements on different kinds of assets, for example, is an intriguing possibility. Our analysis of this, however, raises practical problems. If the Fed were to try to encourage banks to make mortgage loans by putting a low reserve requirement against them and discourage banks from making business loans by putting a high reserve requirement against them, other lenders would more likely begin to fill the gap left by commercial banks. If controls were applied to these other lenders, the open market could move in to close the gap. We could find ourselves in a costly strait jacket of credit controls.

In my view, no one has *the* answer to the question of credit allocation. I'm certain only of one thing: the Fed cannot afford to ignore it and despite practical and philosophical problems should continue to study all possibilities.

In addition to those focusing on the allocation of credit, there are others who advocate fine tuning the money supply and interest rates. We are, of course, familiar with the longstanding dispute between the monetarists and the fiscalists with respect to fine tuning the economy. What's not always appreciated, however, is that both schools have their fine tuners.

Traditional monetarists are mostly anti-fine tuning. They argue that if the Fed tries to vary the rate of growth of money it will do more harm than good. Consequently, it should simply aim for constant growth of money regardless of what happens to interest rates. A new breed of monetarist—one who pores over weekly money supply figures in great detail—has been developing. He puts great stress on very short-run movements in the money supply. Financial houses, for example, put out letters which make mountainous interpretations out of molehill changes in the money supply.

Most of us in the Fed take an eclectic view of the money supply and interest rates. Both are important. On fine tuning, we believe that money growth should not be constant but know from experience that it cannot be controlled precisely. At the same time, to be honest, there is often in the Fed a tendency to pay undue attention to small fluctuations in interest rates. Hopefully, we're getting over that syndrome.

I hope also we can avoid the syndrome of fine tuning the money supply, but it is clear to me that as attention paid to the money supply has grown there has been a tendency to expect too much precision in controlling it. I believe we should try to smooth out extreme movements without yielding to the temptation of trying to *eliminate* all unwanted movements in money. To do even this much smoothing of the money supply will mean we will have to permit more flexibility in money-market rates.

There are a few modifications that would be helpful in this regard. The first has to do with making information about monetary policy decisions more readily available. The Fed now announces its Open Market decision 45 days after the fact. This departure from secrecy has done much to dispel the belief that financial markets would be unduly disturbed or that large financial firms would gain an unfair advantage in money markets. In my view, the next step is to move to a 30-day delayed announcement. If this action has no damaging impact, the immediate announcement of policy decisions should be considered. More information of this nature would promote better understanding of the Fed and its decision-making process.

The second modification has to do with improving money-stock control by the Fed. Member banks have been leaving the System primarily because they must forego earnings on the reserves they are required to hold

[5] Two bills currently pending in Congress would have the Fed direct some form of selective credit controls: S.887 sponsored by Senator Richard S. Schweiker and H.R. 212 sponsored by Representative Henry S. Reuss.

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/hile their nonmember counterparts often re permitted to earn interest on a portion of heir reserves. Declining membership means smaller portion of the nation's stock of noney is directly influenced by the Fed. To ive the Fed greater control over the money upply, I support legislation that would esablish uniform reserve requirements for *all* ommercial banks. An alternative that would lso resolve the problem is Congressional acion to permit the Fed to pay interest on nember bank reserves. While either change vould not be a cure-all, it would enhance the ed's chances of achieving its monetary policy oals.

In sum, it is clear to me that all this pressure or fine tuning and improved credit allocation eflects something basic in our society—the ising standards expected of public officials. It eflects the fact that people are not content to vatch the market exert what they consider dverse effects on sectors they are concerned bout. It reflects increasing pressure for inervention in markets and demand for greater recision in controlling them. But it is also lear that the state of the art is not up to these lemands and that this conflict between rising xpectations and limitations of performance vill continue to be a source of political disute. As the conflict continues, I believe the ed should stand by its free-market hilosophy but it cannot ignore these ressures or take an extreme *laissez-faire* iew in dealing with them.

Intragovernmental Relations: A Delicate alance. A third way in which political coniderations are reflected in how we do our job in the *relation to the Executive and egislative branches of Government*. The Fed eports to Congress, not to the President. The eason for this is the history of the abuse of noney by the Executive. The Secretary of the reasury was once an ex-officio member of ne Federal Reserve Board. He was removed ecause he has to borrow money to pay the ills and might have a tendency to want the owest possible interest rates.

Yet, the relationship between the Fed and the Executive branch is a very delicate arrangement. Obviously, monetary policy cannot go completely off on its own without some coordination with the Government's economic organization. Much consultation and coordination goes on—say 99.99 percent of the time. The important thing is to preserve a degree of independence needed for that .01 percent of the time—that rare and extreme situation in which the Fed disagrees fundamentally with the President. This is the meaning of "independence."

A special case in the Fed's relationship with the Executive branch has to do with Treasury financing. The Federal Reserve System has a great responsibility to see that a new issue of the Treasury does not fail. At stake is the credibility of the Government's credit. There is a danger, of course, in going too far in this direction as we learned during and immediately after World War II. At that time, the Fed supported prices of Government securities to the point where it had become "an engine of inflation." This problem was solved in 1951 when the Fed and the Treasury reached an *Accord* by which the Fed gave up its support of the Government securities market. In return the Fed ever since has pursued an "even keel" policy during periods of Treasury financing. This policy in effect pledges the Fed to a position of neutrality while the Treasury is raising money.

In times when the Treasury is almost constantly in the market, even keel could seriously erode the Fed's flexibility in changing policy. However, in recent years, particularly as the Treasury has evolved new methods of financing, even keel has gradually been getting more flexible. This is no longer a critical problem in the relationship between the Fed and the Executive.

A more difficult question currently has to do with the Fed's relationship with the Legislative branch. The Federal Reserve is a creature of Congress. Congress can take any action it wishes with respect to the Fed, including abolishing it. The immediate question is how much should Congress be involved in

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the details of monetary policy. The Constitution gives Congress the power to coin money and to regulate the value thereof. But this leaves open the question of how much authority it should retain and how much it should delegate to the Fed. I believe it is clear that Congress should retain general oversight but should allow the Fed enough room to make unpopular decisions in the short run that will prove wise in the long run. Also, Congress should not involve itself in the details of monetary policy. For one reason, Congress can be just as susceptible to temporary political pressure as the President. For another, Congress lacks the necessary expertise in monetary policy formation and in its implementation to be calling the day-to-day or even month-to-month monetary signals.

Earlier this year both houses passed a resolution which provided for more direct control over monetary policy.[6] This was a proper step and promises to help focus policy on longer-run objectives. It remains to be seen, however, if Congress uses the tool effectively. As the Fed and Congress proceed to feel their way under the concurrent resolution, a great deal of cooperation and good faith will be necessary on both sides.

A final aspect of Fed-Congressional relationships has to do with the proposal to have the General Accounting Office audit the Federal Reserve System. I can speak from personal experience that the Fed is thoroughly audited now. I can understand that in a post-Watergate environment there would be a desire to provide for the assurance that the billions of dollars of assets are all there. As has been pointed out many times, however, the danger in the proposal is GAO involvement in monetary policy. The Fed already reports all policy actions to Congress and the concurrent resolution further strengthens that reporting relationship. The GAO is not well-equipped to interpose itself between the Fed and Congress on the matter of monetary policy.

CONCLUSIONS

Politics is an art. Central banking is an art. This means that there are no absolutes and that political influences are constantly fluid. For example, recently the emphasis on consumerism has involved the Fed in Truth in Lending, Fair Credit Billing, and Equal Opportunity in Credit. This additional responsibility promises to involve the Fed even further in political considerations. An irony of this is that the Fed tends to get these jobs because it is regarded as nonpolitical.

Thus, pressures toward greater political involvement for the Fed are increasing. Awareness on the part of the public of the Fed is greater than ever. Opinions about what the Fed should do are more pronounced than ever. Pressures on Federal Reserve officials to perform better are greater than ever. Demand for information about what they are doing is stronger than ever. If there were times when officials could sit in their marble halls and mysteriously pull strings that affect the economy without anyone questioning their actions, those times are gone. We must be increasingly open, responsive, and flexible. The challenge will be to accomplish this and yet be as firm and far-seeing as necessary to do our job of securing a healthy economy.

[6] U.S., Congress, Senate, *Referring to the Conduct of Monetary Policy: Report to Accompany H. Con. Res. 133*, 94th Cong., 1st sess., 17 March 1975.

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