FRBSF Weekly Letter

Number 93-21, May 28, 1993

Federal Reserve Independence and the Accord of 1951

Since the establishment of the Federal Reserve System in 1913, the Fed's relationship with both Congress and the President has gone through many phases, and proposals to change this relationship, or the way the Fed conducts monetary policy, have appeared frequently in Congress. For example, Congress amended the Federal Reserve Act in 1977 to require the Fed to establish money supply targets and to report those targets to Congress every six months. In the early 1980s, legislation was introduced, but not passed, that would have required the Fed to establish targets for real interest rates. Other proposals have focused less on the actual implementations and more on the ultimate objectives of monetary policy. For instance, four years ago, Representative Neal (D) held hearings on a bill that would have established zero inflation as the official, and sole, policy objective for the conduct of monetary policy.

In contrast to these earlier legislative attempts to affect either the Fed's objectives or its implementation of policy, Senator Sarbanes (D) of Maryland and Representative Gonzalez (D) of Texas have proposed changing the structure of monetary policy decisionmaking. The intent of their proposals is to provide greater political control over the conduct of monetary policy by increasing the role of the President in determining who makes the decisions about monetary policy.

During other episodes in the Federal Reserve's history, Congress has supported moves designed to increase the Fed's independence from Executive Branch influence. One of the most important of these moves occurred in 1951. In March of that year, the Federal Reserve System and the U.S. Treasury reached an agreement, known as the Accord, that recognized the independence of the Federal Reserve to conduct monetary policy. In the Fed's negotiations with the Treasury, the Fed was bolstered by Congressional support for an independent monetary policy. The modern conduct of discretionary monetary policy in the United States can be dated from the Accord.

The pre-Accord period

During the decade before the 1951 Accord, Federal Reserve actions were dominated by considerations arising from the government's World War II financing needs. The Treasury, faced with the need to raise funds far in excess of tax receipts in order to finance the war effort, wanted to keep interest rates on government securities at low levels. The Treasury view was supported by the Federal Reserve, and the Fed adopted an explicit policy of supporting the government bond market. Particularly during 1942 to 1945 when the government was engaging in massive borrowing, this was clearly an important consideration. As expressed by G.L. Bach, "In this period, Federal Reserve and Treasury officials agreed, with perhaps more patriotic fervor than foresight, that there must be no shortage of money to buy the weapons of war . . ." (Bach 1971, p. 78). In April 1942, the Fed announced that it would maintain the rate on 90 day government bills at 3/8 percent. It did so for the next 5 years.

Whenever a central bank adopts a policy of pegging market interest rates, it gives up control over the supply of money. If the pegged rates are set too low, private sector demand for new government debt issues will be too small to take up the entire issue. To prevent bond prices from falling (and yields rising), the Fed must serve as the residual purchaser. In so doing, the Fed automatically increases the reserves of the banking system, allowing an expansion of the money supply. If the pegged rates are set too high, there will be an excess private sector demand for government securities, and the Fed must sell from its own portfolio of government security holdings in order to prevent interest rates from falling. In the process, banking sector reserves are reduced, leading to a fall in the supply of money.

The Fed continued to support bond prices after the war for several reasons. First, the policy facilitated government borrowing. The low interest rates reduced the cost of government borrowing, the Fed commitment ensured that the Treasury

could always sell its new bond issues since the Fed served as the residual purchaser, and, by insuring the market against capital losses that would occur if interest rates rose, the bond support program increased the overall demand for government debt. Second, any increase in interest rates on government debt would also raise interest rates faced by private borrowers, thereby resulting in reduced private sector investment and increased unemployment. This concern reflected the fears of a postwar recession. Third, it was argued that a rise in interest rates was an ineffectual means of combating inflation.

In the immediate postwar period, the Federal Reserve was increasingly concerned about its inability to prevent inflation as long as it was required to support the price of government debt. With the Consumer Price Index rising more than 14 percent during 1947 and nearly 8 percent during 1948, the Fed believed it needed to control money and credit growth. The Treasury continued to argue that low interest rates were necessary to maintain confidence in government credit and to hold down the cost of government debt, and that controlling the money supply was not necessarily an effective means of reducing inflation. Tensions rose between the Federal Reserve and the Treasury over the Fed's desire to establish monetary control. Marriner Eccles, who had been appointed Chairman of the Board of Governors in 1934 and who openly argued against the bond support policy, was not reappointed by President Truman in 1948.

As long as the Fed supported the prices of long-term government debt, holders of the debt could view these assets as very liquid. With the bill rate held to ⅜ percent since 1942 while the ceiling on long-term government securities was a much higher 2½ percent, there was little demand for Treasury bills. Of the $16 billion in bills outstanding in 1947, the Fed held $15.5 billion. In the middle of 1947, the Fed allowed the bill rate to rise. One consequence of the rate increase was a rise in the Fed's interest income on the Treasury bills it held. To ensure Treasury support for the rate increase, the Fed agreed to turn over 90 percent of its revenue to the Treasury.

In June, 1948, the Federal Open Market Committee, the Fed's policymaking committee, and the Treasury announced that the FOMC would direct open market operations ". . . with primary regard to the general business and credit situation" (*Federal Reserve Bulletin*, 35, July 1949, p. 776). Fed Chairman Thomas McCabe considered this announcement to constitute ". . . the removal of the strait jacket in which monetary policy has been operating for nearly a decade . . . ." At the time, however, the concern was with the economic recession that developed in late 1948. Unemployment rose from 3.8 percent in 1948 to 5.9 percent in 1949, and prices actually declined by 1 percent in 1949. Consequently, the FOMC–Treasury agreement was an agreement to lower interest rates in an attempt to stimulate the economy. It was unclear whether the Fed would have the flexibility to raise interest rates if the problem became one of inflation. In Congressional testimony in 1949, the Treasury Secretary made clear that his interpretation was that the 2½ percent rate on new long-term government securities would not rise.

The conflict between the Treasury and the Fed over interest rate policy led, in 1949, to Congressional hearings on the subject headed by Senator Paul Douglas of Illinois. At this time, Congress was generally viewed as supporting the Fed in its conflicts with the Treasury. According to Stein (1969, p. 258), the hearings ". . . made it clear that any attempt to bring the Federal Reserve forcibly to heel would encounter considerable resistance in the Congress, and that the resistance would have leadership and principles to which there would be a popular response." The Douglas report concluded that the benefits of avoiding inflation were great enough to justify giving the Federal Reserve the freedom to raise interest rates, even at the cost of a rise in the cost of federal debt.

The Accord

In 1950, with the recession over, inflation and the need for monetary restraint once more became a policy concern. During January and February 1951, the Treasury attempted to bind the Fed to the maintenance of low interest rates through public announcements. The Secretary of the Treasury, John Snyder, announced that consultations with President Truman and the Chairman of the Federal Reserve Board had led to a decision that new long-term debt issues would continue to be offered at a 2½ percent interest rate, a view apparently not shared by the Fed. When Fed disagreement became known, President Truman called the entire FOMC to a White House meeting to discuss policy. The White House and the Treasury then announced that the Fed would

continue to support government bond prices. Eccles, who was still a member of the Board of Governors, then released the Fed's confidential minutes of the White House meeting, minutes that contradicted the White House and Treasury claims of a Fed commitment to keep rates fixed.

As a result of these public disputes, the Fed asked the President to initiate negotiations between the Treasury and the Federal Reserve. While the President established a formal committee to resolve the issues of conflict, the actual "accord" between the two institutions was worked out directly between Federal Reserve and Treasury officials. On March 4, 1951, the Accord was announced to the public: "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" (*Federal Reserve Bulletin*, March 1951, p. 267).

Despite the current view that the Accord enhanced the Fed's ability to conduct an independent monetary policy, the language of the Accord did not specifically address the issue of conflict—would the Fed be expected to continue to support bond prices? In fact, at the time many commentators felt the Accord was not the final resolution of the Treasury-Fed disagreements. However, it soon became clear that the Fed had in fact been freed from its obligation to support the price of government bonds.

After the Accord

Interest rates gradually rose during the two years following the Accord, and market interest rates became much more volatile as the Fed was now able to pursue more activist policies. However, Shiller (1980) shows that once short-term interest rates on commercial paper were corrected for inflation, real interest rates actually became much less volatile over the 20 years following the Accord. More importantly for the longer-term conduct of U.S. monetary policy, the Accord separated the determination of debt-management policy from that of monetary policy. This was a necessary separation for controlling the money supply and for providing the Fed the means for controlling inflation.

Did the Accord actually give the Fed independence from the Executive Branch to conduct monetary policy? At the end of March 1951, just three weeks after the Accord was announced, President Truman appointed William McChesney Martin, the Treasury official who had negotiated the Accord for the Treasury,, as Chairman of the Federal Reserve Board, a position he held until 1970. Martin made clear, however, his view that the Federal Reserve was an independent agency of government, responsible to the Congress.

It is important that monetary policy be unconstrained by debt management considerations. Requiring the Fed to maintain interest rates at levels that are too low runs the risk of increased inflation. The conflict between the Fed and the Treasury that led to the 1951 Accord did, according to Stein, serve a useful purpose: "If monetary policy had floated free of the [interest rate] pegs without a direct confrontation, the importance of flexible monetary policy might never have become so clear as it did to large numbers of people, and the Federal Reserve would not have been left with so vivid a reminder of the dangers of compromising its independence" (Stein 1969, p. 278).

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Printed on recycled paper with soybean inks.

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