THE FED AS AN INSTITUTION

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I found Professor Timberlake's (1986) paper very interesting and learned a great deal from it. However, I had trouble deciding on my comments. It dawned on me that Professor Timberlake's paper summarizes five different topics, each of which deserves a monograph. The difficulty, then, is in reconstructing the five monographs summarized in this paper and developing appropriate comments since I have the summaries but not the original monographs.

In the first section of his paper, "The Pre-Fed Institutional Milieu," Timberlake reviews the financial institutional environment before the Federal Reserve was created. His description of what the monetary system looked like before the Federal Reserve came into being is extremely helpful. The pre-Fed monetary system featured four institutions: first, the gold standard was at the base of the system and provided the economy with high-powered money; second, the national banking system acted as a reserve depository for non-national banks; third, the independent Treasury occasionally manipulated its cash balances to effect changes in the quantity of reserves of the banking system; and fourth, the private clearinghouse system was able to serve as a lender of last resort by extending the means used for payments when the banking system was threatened with a shortage of reserves. The gold standard and the national banking system were regarded as acceptable but inadequate; the independent Treasury was seen as having undesirable interventionist characteristics; and the private clearinghouse system was viewed as a haphazard organization doing things of a make-shift nature that were possibly illegal. The Federal Reserve Act was, therefore, an attempt to channel the powers then exercised by the Treasury and the private clearinghouses into a formally structured institution that would be at once legitimate, independent, scientific, and efficient.

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In section II, "Institutional Aspects of the Federal Reserve Act," Timberlake deals with the nature of the Federal Reserve Act. And here Timberlake makes his point very well. In the discussions prior to enactment of the Federal Reserve Act, the notion of a "central bank" was definitely not a popular concept. It was politically unacceptable. Another label such as "A Regional Reserve-Holding Institution" had to be used. In fact, it is clear from his quotations that "federal bank" was almost a dirty word. If one wanted to gain support for a central bank, one would not use that term.

But if the Federal Reserve was not supposed to be a central bank, what was it supposed to be? In Timberlake's words, "if the Fed fetus was not to be a central bank, what was it in the eyes of its sponsors?" At this point, two concepts emerged. One group saw the Fed as a supreme court of finance; the other group as a public utility regulator similar to the Interstate Commerce Commission (ICC). And just as the ICC was established to keep railway rates "low" so the Fed should provide the public with a low rate of interest.

Consider now what the Fed would be doing in this kind of formulation. The Fed would operate as a "scientific" regulator of the payments system, the analysis presumably carried out by managers who in turn would be guided by scientific experts. They would have to determine the kinds of commercial paper banks could bring to the Federal Reserve Bank for rediscounts. They would determine what paper was "eligible" for the discount window. Eligibility then was taken to mean "real bills," issued for productive purposes at short-term—referred to in the literature as "two name, self-liquidating, short-term commercial paper." And, as is well known, the real-bills doctrine held that if the banking system restricted itself to that kind of paper, there would be no problem with either overissue or underissue of deposits. So much for what the Federal Reserve was supposed to be doing.

Recall now that advocates of the real bills approach to commercial banking viewed that doctrine as providing the banking system with a self-regulating adjunct to a self-regulating gold standard. The Federal Reserve on this approach was to do in the short run what the gold standard did secularly. The Fed was to provide seasonal money commensurate with seasonal production of commodities. It would adjust the money stock to the needs of trade; and, more importantly, it would displace the discredited "independent" Treasury. The Fed would also assume the clearinghouse function for banks. Under this approach, the Fed would provide the emergency relief in a crisis on an official, legal, and scientific basis as opposed to having the clearinghouse doing it in a manner raising some question whether what they were doing was really legal.

Timberlake also points out that there was some awareness of, and some discussion, that there might be an inflationary bias since Federal Reserve notes would be fiat money. But Carter Glass, a principal sponsor of the bill, somehow convinced himself that if the banking system restricted itself to real bills—two-name self-liquidating, short-term commercial paper—there could be no inflationary bias.

But some of the discussants of the Federal Reserve Act worried a little bit. The monetization of commercial bank assets, no matter how real these assets were, requires some discretion. And how does one know whether or not one is dealing with a real bill? If the bankers and the Federal Reserve in negotiating credit extensions and new money are overly conservative, they will generate a deflation. But if they are too generous, they will provoke an inflation. A gold standard sets limits on their judgments, but some disequilibrium can result before the gold standard restraints come into being.

In the third section of his paper, "Congressional Norms in the Banking Act of 1935," Timberlake focuses on the period following the Great Depression. He points out that the view prevailing when the 1935 banking act was enacted attributed the troubles in the 1929–33 period to wild speculation and stock-market gambling. There was no clear conception that there may have been a serious, and profound error in the monetary theory and practice of the Federal Reserve. Timberlake discusses Senator Steagall's conception of how to avoid monetary and financial disasters. His approach was to replace the "wrong people" with the "right people." One of the important changes brought about in the 1935 Act was to abandon the notion of eligible paper and to concentrate instead on open market operations.

An important issue that emerged was the idea of control. The original Federal Reserve Act provided for regional control by the Federal Reserve Bank with general oversight by the Board of Governors. The Federal Reserve banks were seen as super-commercial banks vested with a public interest, but a public interest that would operate through the medium of member banks. But since the banking system was the vehicle, the bankers would be in control because they alone had the expertise to manipulate the system properly. And what was good for the banks, namely, adequate credit relief at critical times, was also good for the general public. But in the course of passing this act there was a major change, and the control went from regional Federal Reserve banks to the Board of Governors in Washington.

In the fourth section of the paper, Timberlake deals with "The Federal Reserve System after 1935." The accord between the Treasury and the Federal Reserve was reached in 1951. From then until the mid-1960s, the Fed did nothing blatantly exceptionable. Money growth was fairly low and the rate of change in prices was close to zero for 15 years. The two major mistakes that occurred after 1965 were first, the Johnson administration pressured the Fed to inflate the monetary system in order to monetize its deficits; and second, the U.S. removed the gold cover against Federal Reserve liabilities. With this later action, we removed the anchor of the international monetary system and opened the door completely to monetary acceleration and inflation.

In the fifth section, Timberlake discusses "The Monetary Control Act of 1980," and in his concluding section recommends privatizing the Federal Reserve, abolishing open market operations, and distributing the official stock of gold to the public.

Timberlake has carefully studied the origin of the Federal Reserve and is an authority on this subject. He is puzzled by how the conception of the central bank that the Founders thought of as an institution with fairly limited powers became, in fact, the all-powerful institution that the Fed is today. The puzzle is further compounded by the fact that the Fed's record is not all that good.

The Fed has an amazing record of gaining in power even when their actions have contributed to the crisis which the new powers are designed ostensibly to prevent. And while the Fed Chairman and the Fed are held in high esteem right now in many financial circles, the fact is that their overall record, especially since 1971, has been rather poor. And yet, every year the Fed seems to be getting a little stronger.

To explain why the Fed is such a powerful institution, it may help to focus on the following question: Why is it that the policy activists, the fine tuners, the interveners, and the redistributors all seem to be drawn from the fiscalist camp? And why is it that monetarists apparently seem to be more favorably disposed toward rules and guidelines? On consideration of this question, I discovered that monetarists had an activist phase too. In the 1920s, when open market operations were first discovered, many activists and the fine tuners oriented themselves toward monetary policy. And then after the Great Depression and the debacle of the 1930s, some of these early activists developed greater appreciation for *rules* and *guidelines* which emerged as the postwar monetarism in the 1950s. And just about that time, other activists, impatient with rules and guidelines, adopted fiscalism.[1]

[1]See Fand (1970).

What we apparently observe is a kind of cultural lag. When one first begins, one tends to favor activism; and, as one becomes older, one becomes a little more conservative. If allowance is made for this fact, it could explain why the Federal Reserve was able to gain considerable power during a period when monetary fine tuning appealed to the activists and fine tuners of the 1920s.

Timberlake, in discussing the Monetary Control Act, makes some very serious charges about the Fed, and I would like to see this case documented in greater detail. It would be worth having a definitive record of that.

In connection with some of the errors that the Fed has made, many of us wonder why it is that in 1984 we had about 5 to 6 months of almost zero money growth. We also wonder why the Federal Reserve seemingly announced that it was going to operate with a free reserve target. This free reserve target was very carefully reviewed in the literature some 25 years ago and was thoroughly repudiated. Indeed, some of the annual reports of the Federal Reserve in the early 1960s suggest that the Fed itself suspected that there was something wrong with this doctrine.[2] Yet, all of a sudden, this doctrine comes to life again in 1984.

I am not suggesting that doctrinal error is exactly, and precisely, what misleads the Fed. Some people suggest that while the Fed talks about free reserves, it actually uses an interest rate target and that free reserves may just be a code word for an interest rate target. The fact is we had 5 to 6 months of almost flat money growth in 1984 and a sluggish economy for almost a year under this free reserve approach, and I do not know why the Fed persists in this approach.

Timberlake's final recommendations—that we should privatize the Fed, distribute the official gold stock, freeze the monetary base, and abolish open market operations—are bold suggestions. They are of a far-reaching significance and need to be explained and supported in greater detail.

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[2]See Fand (1963).

INHERENT CONFLICTS OF U.S. MONETARY POLICYMAKING

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I have come to the realization that perhaps the best contribution I can make to the debate over monetary policy is to discuss the "inherent conflicts" of monetary policymaking as it is currently conducted in the United States. I do not presume to be able to discuss all the problems of policymaking, nor can I presume to prescribe acceptable solutions to the multitude of problems that have vexed so many for so long. Instead, I would like to present a few of the most meaningful impressions that I gathered during the seven years in which I participated in monetary policymaking. I will leave it to you to decide which of these impressions are valid and how the problems they suggest might be corrected.

In line with the present emphasis on "truth in labeling," I must remind you that my impressions are somewhat subjective. I anticipate that some of my colleagues in the policymaking process will, no doubt, disagree with each and every one of them, and that some may even have a totally different view of what the process is all about.

A Policymaker's View of the Policymaking Process

What Monetary Policy Should Be

First, let me state what I believe monetary policymaking should be. Under our institutional arrangement, the Federal Reserve System possesses, for all practical purposes, only one tool of policy implementation: open market operations that inject or withdraw bank reserves into and from the banking system. It follows that, if there is a primary goal, or a set of *consistent* goals that we desire to achieve, monetary policy must be, simply, a process for producing the changes

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