7-2010

Woodrow Wilson and the Federal Reserve

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Woodrow Wilson and the Federal Reserve

By: Allan H. Meltzer

I am honored to participate in this remembrance of President Woodrow Wilson and his major role in creating the Federal Reserve System as a unique experiment in public-private partnership. The federal government was small during non-war periods in the 19th and early 20th century. Relative to GNP, federal spending or outlays remained between 2 and 3% of GNP. That compares to about 25% today. That's a main reason that the federal government did not have a role, but it is not the only reason. Both the public and politicians understood that keeping the government far away from money creation was the best assurance against inflation that could be had. That's advice that officials repeat but ignore today.

The United States did not have a central bank after President Andrew Jackson refused to renew the existing Bank's charter in 1836. During most years from 1836 to 1913, the gold standard regulated the quantity of money, but anti-gold standard agitation was widespread. Farmers, merchants and many ordinary citizens thought the gold standard too rigid and inflexible. Several deep recessions in the 1890s and in 1907 strengthened the case for greater flexibility.

Bankers had a different complaint. They wanted to compete with London banks in the business of moving the annual cotton and grain harvests to foreign buyers. To finance the large volume of crop-moving loans in the autumn, they needed a place to discount the loans made to merchants who bought the crop. The London banks could discount at the Bank of England; domestic banks wanted an American discount facility.

This common interest made it easy to agree on reform of the financial system and creation of a new entity. The most contentious issue was not whether the new entity would be authorized but over who would organize, control, and operate it. Bankers wanted to copy the Bank of England, run by bankers at the time but operating on gold standard rules. Farmers and merchants wanted none of that. There would be no agreement to establish the monetary agency until the Congress resolved the control issue.

President Wilson, a former professor of political science, cut the Gordian knot by inventing the public-private partnership. To satisfy the bankers, the Reserve banks would be run by bankers. To satisfy the farmers and merchants, the Reserve banks would be semi-autonomous, meaning under local control and therefore conscious of local conditions. A publicly appointed supervisory board in Washington was charged with monitoring actions of the regional banks. Local or regional banks could set borrowing rates. Wall Street would not squeeze the local economy. Much has changed in 97 years, but antipathy toward Wall Street seems as strong as in the past.

One of the big changes is the diminished influence of the Reserve banks. In the early years, the Reserve banks dominated policy decisions. The Banking Act of 1935 shifted the balance of power toward the politically appointed Board. Still, some anti-banker members of Congress complained periodically that Reserve bank presidents voted on national policy but were not confirmed in office by Congress. There has never been evidence of malfeasance, but the absence of evidence did not satisfy the critics. The most recent financial legislation prevents Reserve bank directors that come from member banks from voting for the president of the bank. This is another step toward weakening the private part of the private-public partnership.

A Virginia Congressman named Carter Glass played a prominent role in shepherding the Federal Reserve Act through Congress. Glass later became Treasury Secretary and Senator from Virginia. For years, he delighted in asking Federal Reserve officials if they ran a Central Bank. The expected answer was an emphatic no. We had an association of semi-autonomous Reserve banks, not a central bank.

In fact, the initial Federal Reserve Act created an institution with limited powers. It was independent of government, but the Secretary of the Treasury and the Comptroller of the Currency served ex officio as members of the Federal Reserve Board. To honor his commitment to independence, President Wilson did not invite appointed members of the Federal Reserve Board to White House functions. And the Treasury Secretary and the Comptroller usually chose not to attend Board meetings.

The Federal Reserve's power to control money was limited in a more fundamental way. I will stress three features that have since disappeared. First, the United States remained on the gold standard, so the sustained growth of money depended on attracting gold inflows from abroad. Gold standard rules guided changes in interest rates. When gold flowed in, markets lowered interest rates and the quantity of money and credit increased. Gold losses reversed these changes.

Second, the Federal Reserve Act was also based on the commercial credit or real bills system of control. Remember that one reason for establishing the Federal Reserve was to have a facility that could discount commercial and agricultural loans. The Federal Reserve was authorized to expand money and credit when bankers asked them to lend—that is rediscount—against commercial and agricultural credits. The idea was that these loans would be self-liquidating. When the goods were sold to final users, the loan and rediscount would be repaid. Because the loans were self-liquidating, proponents of the commercial credit theory believed discounting such loans could not produce inflation.

The purpose of the restriction to rediscounts of commercial credit was to separate money creation from financing so-called speculative and non-commercial credit. This ruled out Federal Reserve purchases or rediscounts of mortgages and stock exchange credit because that was considered inflationary. At the time and until 1927, nationally chartered banks could not lend on mortgages.

Third, the Federal Reserve was barred from lending to the Treasury. The founders understood well that pressure to hold down interest rates on Treasury borrowing by issuing money was inflationary. It had to be avoided.

The three restriction—the gold standard, real bills, and no loans to the Treasury—limited Federal Reserve powers. The Federal Reserve could respond to demands for credit and money, but it was not supposed to initiate expansion or contraction on its own initiative. If gold changed or bankers asked for or retired discounts, it responded. Otherwise not.

All three restrictions are gone. The modern Federal Reserve is a central bank, the world's principal central bank. The United States is no longer an emerging economy, as in 1913. At least since World War 2, it has been the world's principal military, cultural and monetary power. When the world faces increased financial or economic uncertainty, some run for gold but most run to acquire dollar securities. The gold standard and the real bills doctrine are long gone and unlikely to return.

Gradually, Congress relaxed the outright prohibition on direct loans to the Treasury. The Federal Reserve is allowed to lend to smooth periods of Treasury borrowing. Far more important, in the 1920s the Federal Reserve pioneered the use of open market operations to adjust interest rates and money. The Federal Reserve became an active operator in financial markets. With the massive increase in federal government debt during World War 2 and after, open market operations in Treasury bills became the principal means of adjusting interest rates. Although the Fed continues to limit direct loans to the Treasury, it makes an exception for loans against foreign exchange collateral. And while it restricts its direct purchases of Treasury securities, it can buy unlimited amounts in the market after the Treasury securities have been sold to others. This removes the earlier prohibition.

The Federal Reserve is no longer a passive participant awaiting borrowers. It sets the short-term rate. It chooses the amount of reserves and money that it supplies.

The current Federal Reserve is as far from the one President Wilson signed into law as his Pierce Arrow is from one of today's SUVs. Some of the changes were inevitable. Some are appropriate. Some are mistaken.

A modern electorate expects its government to lessen the severity of cycles in unemployment, so it is appropriate that the Federal Reserve now works actively to restore some measure of full employment. The classical gold standard does not permit the central bank to respond to unemployment. It restricts action to controlling the fixed price of gold. If that requires prolonged periods of unemployment, the public must accept that outcome. That's the main reason why countries no longer commit to the gold standard.

The current Federal Reserve has a dual mandate. Congress has told it to limit unemployment and recessions and to prevent inflation. In practice, the Federal Reserve puts most of its effort into reducing unemployment. Reducing actual or expected inflation gets less attention. The early years under Chairman Volcker, 1979-82, is an exception. Reducing inflation became the main goal.

Currently the Federal Reserve again gives principal weight to unemployment and recapitalizing the large banks. It does nothing to reduce the longer-term inflation problem represented by more than $ 1 trillion dollars of excess reserves. These reserves can at some future time permit banks to increase money and credit at an inflationary rate. Many, but not all of the Federal Reserve's open market committee, think inflation control can wait. That was the mistake they made in the 1970s that brought the Great Inflation. I am pleased to note that my friend Tom Hoenig repeatedly dissents from current policy.

One of the undesirable changes at the Federal Reserve is the loss of independence. The original Federal Reserve was independent of government. The current Federal Reserve is not. This is not the first time that the Federal Reserve sacrificed independence. The chapter in my history on the 1930s has the title "In the Back Seat." The Federal Reserve struggled against Treasury control, but it usually did what the Treasury wanted. That meant keeping interest rates low to reduce the cost of financing the government deficit. Then came the war. The Federal Reserve kept interest rates low. It struggled to regain independence in the postwar years, but it didn't succeed until 1951, almost 5 years after the war ended. Support of Senator Paul Douglas and some other prominent members of Congress was a critical part of the pressure leading to renewed independence.

After a period of independence during President Eisenhower's term, the Federal Reserve helped the Treasury finance President Johnson's deficits for the war on poverty and in Vietnam. That started the Great Inflation. Because the Federal Reserve gave pride of place to reducing unemployment, the 1970s became a decade in which both inflation and unemployment rose. Congress and Presidents Nixon and Carter wanted low unemployment. The Federal Reserve tried to accommodate them. It failed. As Chairman Volcker explained at the time, there was no trade off of slightly higher inflation for reduced unemployment. Inflation and unemployment rose together during the 1970s.

Once again, we have high and persistent unemployment. The current Federal Reserve has sacrificed the independence that Chairman Volcker rebuilt. It has helped the Treasury finance the huge budget deficit. It acceded to the Treasury's request that it purchase more than $ 1 trillion of mostly long-term. Illiquid mortgages. Never before was the Federal Reserve balance sheet full of illiquid, long-term debt. And perhaps most damaging to its long-term interest, it has shown the Congress that it can quickly find the money to bail out some failing private lenders. That's a terrible lesson for some members of Congress to learn—that they don't need to appropriate money to help their friends and constituents. The Fed can do what they want done.

We cannot bring back the Wilson-era Fed, nor should we want to do so. But we should want to restore Federal Reserve independence, ending credit allocation and financing fiscal deficits. It will not be easy, and I don't think it can happen without support in Congress.

The early Fed's actions were restricted by the gold standard rule and the strong commitment by the public to balance the budget in non-war years. Once the gold standard ended, Federal Reserve action was unrestricted. It could create inflation at one time, unemployment at another. Throughout its history, it has achieved only a few periods of relatively steady growth and low inflation. I count the years 1923 to 1928, 1953-58, and the period known as the great moderation, 1984-2003.

During the Great Moderation, the Fed mostly followed a rule, known as the Taylor rule. I say mostly followed because it exercised bounded discretion. It abandoned the Taylor rule in 2004. It should go back to the rule. We must convince our Congressional representatives that we want them to endorse a quasi-rule that limits, but does not remove, Federal Reserve discretion. We need to do that now before the Treasury pressures the Federal Reserve to help it finance the unsustainable budget deficits that loom in our future.