INSTITUTIONAL EVOLUTION OF FEDERAL RESERVE HEGEMONY

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> If for any reason—and God grant it may never be so—these boards of control [in the 12 Federal Reserve Banks and the Board of Governors] should lack the wisdom and the courage to do their duty, we would still be subject to all the disasters that now befall us, because of the fact that the control is not wisely exercised.
>
> —Rep. Charles Korbly[1]

The monetary system of the pre-Federal Reserve era was supposed to lack form-seasonal elasticity—that is, the ability at critical times to convert one form of money into another without undue change in the total quantity of money. The role of the gold standard, which was the dominant monetary institution of the time, was to provide automatically a rate of growth in the quantity of base money compatible with the rate of growth in the economy's real output. It could not be expected to make short-run adjustments that developed fundamentally from the workings of the fractional reserve banking system. The creation of the Fed is viewed conventionally as a step toward a payments system with the desired characteristic of monetary elasticity, and the Fed is then assumed to have pursued forthrightly monetary-economic goals in an environment of political independence.

In point of fact, this picture is at best wishful thinking. It omits several factors that led to the formation of the Federal Reserve System; it overlooks the technical failure of the Fed to perform as specified in its first 20 years of existence; and it ignores the political

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[1]U.S. Congress, *Congressional Record* 50, pt. 5 (10 September 1913): 4663. Hereafter, all references to the *Congressional Record* are abbreviated by CR.

activism that has altered completely the institutional *raison d'etre* of the Fed since the World War I period.

This paper attempts to trace the political evolution of the Fed in conjunction with the changes in its institutional structure that have made these changes operational.

I. The Pre-Fed Institutional Milieu

At least four other institutions were active in monetary affairs before the Federal Reserve Act was passed. First, the gold standard was the base of the system. It operated without human manipulation to provide the economy with high-powered money. A second institution was the national banking system, which was then a reserve-holding group of larger, stronger, urban banks for their "country" correspondents. National banks, however, were unable to function as true bankers' banks by lending to their client banks in times of crisis because, as profit-seeking institutions in competition with each other, they could not retain a quantum of uncommitted reserves.

A third institution was the independent Treasury, which was simply the U.S. Treasury Department structured to be independent of the banking system. In its original form it was supposed to have kept its own cash balances, so that its fiscal activities did not in any way upset the banking system. However, at opportune times, its presiding secretaries became aware of the leverage that Treasury balances could have on the rest of the monetary system and responded by initiating various monetary policies that were notable for their ingenuity if not for their legal propriety. Over the decades the independent Treasury did a complete about-face. Initially formed to be aloof and apolitical, it emerged as a policy-wise and interventionist agency (Timberlake 1978, pp. 62–83, 171–85).

The fourth institution, the private clearinghouse system, appeared slightly later than the independent Treasury. Originally a technical arrangement for economizing bank clearings, clearinghouses became the private system's version of a lender of last resort. While the system worked well and had the proper checks and balances, it also had an aura of illegality and manipulation that populist politicians associated with their pet bogeymen on Wall Street (Timberlake 1984).

In sum, the pre-Fed system featured four institutions: (1) an operational gold standard secularly regulating the quantity of money in the economy; (2) a national banking system which acted in part as a reserve depository for non-national banks; (3) an "independent" Treasury that occasionally manipulated its fiscal balances to effect changes in the reserves of the banking system; and (4) a private

clearinghouse system, which, while illegal in its policy role, was instrumental in extending the media used for payments when the banking system was threatened with critical drains of reserves. Of these institutions, the gold standard and the national banking system were regarded as acceptable but inadequate. The "independent" Treasury was seen as having assumed undesirable interventionist characteristics, while the clearinghouse system was viewed as a haphazard and illegal make-shift. The Federal Reserve Act therefore, was an attempt to combine and channel the powers then exercised by the Treasury and clearinghouses into a formally structured institution that would be at once legitimate, independent, scientific, federated, and efficient.

II. Institutional Aspects of the Federal Reserve Act

The characteristics looked for by Congress were emphasized in the debates over the Federal Reserve bill in the fall of 1913. Federal Reserve Banks were *not* to be central banks or a central banking system. This feeling was often expressed in the actual debates over the Federal Reserve bill. One prominent congressman, Everis Hayes of California, stated: "Our people have set their faces like steel against a central bank" (*CR* 50, pt. 5 [1913]: 4655). An influential senator, John Shafroth of Colorado, argued likewise: "The Democratic Party is opposed to a central bank, and well it should be, because of the fact that it would concentrate in one place such a combination of wealth as could be used to the disadvantage of the entire people of the United States" (*CR* 50, pt. 6 [1913]: 6021).

The popular (not to say Populist) image of a central bank came through as a large banking monolith, centered in Wall Street—one that controlled money and interest rates for the benefit of bankers. "Central bank," therefore, was a term that was politically unacceptable, particularly to Democrats. Another label had to be used, such as, "a regional reserve-holding institution." Some congressmen were more realistic. "The central bank does not consist of a vault . . . [or] a mass of money," noted Senator Gilbert Hitchcock of Nebraska. "The central bank consists of central control, and that is provided in this bill. . . . When you get your control centralized, you have a central bank" (*CR* 51, pt. 1 [1913]: 702).

If the Fed fetus was not to be a central bank, what was it in the eyes of its sponsors? Two concepts emerged from the debates. One saw the Fed as a supreme court of finance; the other thought of the Fed as a public utility regulator similar to the Interstate Commerce

Commission (ICC). Just as the ICC was to keep railway rates "low," so a Federal Reserve Bank, stated Hitchcock, "is established as a public utility. It is not to make money; it is to protect the depositors against loss; and it is to give the borrowing public a stable and uniform low rate of interest" (*CR* 50, pt. 6 [1913]: 6016).

Hitchcock, while a Democrat, was also a spokesman for the populist segment in Congress. This group had devised a separate bill from that of the orthodox Democrats. Their philosophy was expressed forthrightly by Hitchcock. "We believe in Government control, real and actual, all the time," he said; "and we do not believe that the banking interests in any community should be intrusted with that power [to control the monetary system]." Bankers were "money devils"; and ". . . the people of Nebraska want to have the reserve banks owned by the people and not the banking interests." (*CR* 51, pt. 1 [1913]: 703).

Shafroth, a more conventional Democrat, opposed Hitchcock. He observed that the bill for the Fed was "framed on the theory that this is a bank of banks for the purpose of preventing runs on banks. . . . Every national bank in the United States," he concluded, "is a people's bank. . . . You do not want to mix a bank of banks with a people's bank" (*CR* 51, pt. 1 [1913]: 703).

As a supreme court of finance or a quasi-ICC, the Fed would operate as a "scientific" regulator of the payments system, so it would require scientific expertise by its managers. In particular, they would have to be able to determine that the commercial paper banks offered for rediscount to the Federal Reserve Banks was "eligible." "Eligible paper" meant real bills issued for productive purposes at short-term. As Charles Korbly observed, "[s]uch paper springs from self-clearing transactions." "Checks and bills," said Korbly, "are the offspring of sales." Thus, Korbly reflected Bagehot's principle: "It is the duty of the banker to discount freely for his customer in a crisis or panic. The only limit . . . to discount is the limit to good commercial paper." The role of the Fed by this canon was to enhance and guarantee the production of money in accordance with the production of goods. (*CR* 50, pt. 5 [1913]: 4659–62).

Presiding over the scientific application of the real bills principle would be the Federal Reserve Board. The Reserve Banks would discount real bills, and the Federal Reserve Board would act as a referee in determining the validity of the real bills. "If a member bank presents the right kind of paper, such as is required by law," stated Knute Nelson of Minnesota, ". . . it shall absolutely be entitled to have a discount for that paper" (*CR* 51, pt. 1 [1913]: 523). Nelson

and others who argued in this way clearly believed that the real bills-eligible paper doctrine left no element of discretion in the bill.

Nelson's logic was sound. If eligible commercial paper were scientifically identifiable, no excess or deficient issue of money could occur. However, one senator, John Weeks of Massachusetts, said that he had tried to get "12 or 15 banking men" to give a precise definition of eligible paper and not one of them could do it. Nevertheless, he felt that the Federal Reserve Board when appointed would be able to make the correct definition. (*CR* 51, pt. 2 [1913]: 1074).

Senator Elihu Root of New York, however, cautioned his fellows on the fair weather nature of eligible paper. "The standards which are applied in the exercise of that kind of judgment [i.e., evaluating the soundness of paper offered for discount] become modified by the optimism of the hour," he warned, "and grow less and less effective in checking the expansion of business" (*CR* 51, pt. 1 [1913]: 967). Root here put his finger on the inadequacy of the real bills doctrine—the fact that the money value of every bill depended on the judgment of the banker who bought it.

Congressmen's views on the proper characteristics for the new Fed—on the relationship of the Board to the Fed Banks and on the connection between the Fed and the commercial banking system—seemed at times diverse. In addition to the antipathy toward a central bank, the consensus seemed clearly in favor of a nondiscretionary, self-regulating, reserve-mobilizing institution. In no sense was the gold standard to be violated. In fact, a special provision in the final bill stated: "Nothing in this act . . . shall be considered to repeal the parity provisions [on gold] contained in an act approved March 14, 1900" (*CR* 50, pt. 5 [1913]: 5101).

The Federal Reserve System was to be a self-regulating adjunct to a self-regulating gold standard. It was to do at short term what the gold standard did secularly—that is, provide seasonal money commensurate with seasonal productions of commodities. It was to adjust the money stock to the needs of trade. It was to displace the discredited "independent" Treasury. It would also assume the clearing function for banks; and it would put the clearinghouse operation of providing "emergency" currency in a crisis on an official, legal, scientific plane.

Near the end of the debates, some congressmen expressed concern over the possibility that the new Fed would become an engine of inflation because Federal Reserve notes would simply be another fiat money. Carter Glass, the principal sponsor of the bill, challenged those who made such a charge "to name a single lexicographer on the face of the earth . . . to justify [such a] characterization of these

notes." Any possible inflation from their issue, he claimed, would be checked "first, by the limited supply of gold; second, by the limited amount of short-time commercial paper; third, by the banking discretion of the individual bank; fourth, by the banking discretion of the regional reserve bank; fifth, by the banking discretion of the Federal Reserve Board, with a broad view of conditions not in a single district, but throughout the country" (*CR* 50, pt. 7, app. [1913]: 563–64).

Only the first of Glass's alleged constraints against inflation was or could be effective. The gold standard law permitted the monetization of gold on fixed dollar terms. No one ever had to define "eligible" gold for monetization purposes because all gold was eligible. Monetization of gold included no human judgment of the dollar value of the thing monetized.

The monetization of commercial bank assets, however, no matter how "real" those assets, requires all the "discretion" alluded to by Glass. If the bankers and central bankers negotiating credit extensions and new money are overly conservative, they will generate a deflation; if they are too ebullient, they will provoke an inflation. A gold standard sets limits on their judgments, but much disequilibrium can result before the gold standard's constraints are realized.

III. Congressional Norms in the Banking Act of 1935

The grand hopes for monetary stability from the creation of the Federal Reserve System were dashed by the experience of the thousands of bank failures that occurred between 1930 and 1933 and the economic contraction that accompanied and followed them (Friedman and Schwartz 1963, pp. 407–19). Organization of the Fed as an official lender of last resort had necessitated abandonment of the clearinghouse lending system that the commercial banks had erected on their own behalf in order to isolate bank liquidity problems. The key actions in the past had been restriction of payments—that is, the greatly retarded conversion of bank liabilities into base money, and the infusion of clearinghouse currency into major transaction arteries. During 1929–33, the Fed not only did not take over these functions, it spoke out against them and became frozen in its own bureaucratic moraine (Friedman and Schwartz 1963, pp. 327–30; Timberlake 1984).

The 74th Congress that convened in 1935 considered economic problems paramount, and monetary conditions were chief among the economic issues that demanded treatment. The general consensus of congressional opinion was that the Great Crash and ensuing

depression were caused by (not just correlated with) wild speculation and stock gambling encouraged by loose credit policies of the Federal Reserve System (*CR* 79, pt. 11 [1935]: 11915). Not only had the Fed been remiss in preventing speculative credit excesses, its vaunted power had inadequate definition and oversight. It was marked especially by uncertain lines of authority. To correct this deficiency, Congress considered a new "reform" bill that was to change drastically the institutional structure and hegemony of the Federal Reserve System.

The sponsor of the bill (H.R. 7617), which eventually became the Banking Act of 1935, was Henry Steagall of Alabama who was referred to by Carter Glass, his counterpart in the Senate, as the "worst inflationist in the country" (*CR* 79, pt. 11 [1935]: 11825). Steagall noted critically how improperly the eligibility doctrine had been applied. Many member banks, he complained, "went down in ruin because of the arbitrary, inelastic, straitlaced eligibility requirements of the Federal Reserve System, as a result of which solvent banks were unable to get the accommodations to which they were entitled" (*CR* 79, pt 13 [1935]: 13706).

The solution Steagall offered, and the one endorsed by a majority of Congress, was to replace the "wrong people" with the "right people." The wrong people were the bankers who managed the Federal Reserve Banks. The proper group to manage the system was the Board of Governors. The pending law would allow the president of the United States to reconstitute the Board and bring "the System with its vast resources into full harmony with the advanced [sic] policies of the present [Roosevelt] administration. We all know," he concluded in a classic statement of men-versus-law, "that it does not matter so much what we write into the law as it does who administers the law." By diverting control of the System from the 12 Federal Reserve Banks to the Federal Reserve Board, the credit and monetary policies of the country would be exercised in the name of the "people of the United States" (*CR* 79, pt. 13 [1935]: 13706).

The spokesman for the bill in the Senate was Carter Glass, the above-mentioned sponsor of the original Federal Reserve Act in 1913 when he had been a member of the House of Representatives. Glass recounted how the Open Market Committee was supposed to enforce the impact of the discount rate through the buying and selling of securities. "It is now proposed," he said critically, "to make the open-market committee the supreme power in the determination of the credits of the country. No such thing was intended [by the Federal Reserve Act], and no such thing should ever be done." Glass objected especially to the Federal Reserve Board being the Open Market

Committee because, he claimed, the Board "does not have a dollar of pecuniary interest in the Reserve funds or the deposits of the Federal Reserve banks or of the member banks . . . " (*CR* 79, pt. 11 [1935]: 11778).

The compromise solution for the bill reached by the House-Senate conference committee was to reconstitute the Open Market Committee in the form it has had ever since—that is, five Fed Bank Presidents and the seven members of the Board of Governors. Board members being a majority, the execution of monetary policy became safely lodged in the "representatives of the people."

The debate on the bill emphasized a number of facts and impressions that had emerged from the Fed's first 20 years of operation. A major problem was the dilemma of control. The original act had provided for regional reserve control by the Fed Banks with general oversight by the Board. The Fed Banks were seen as super-commercial banks vested with a public interest, but a public interest that would operate through the medium of the member banks.[2] Since the banking system was the vehicle, bankers had to be in control because they alone had the expertise to manipulate the system properly. What was good for the banks—namely, credit relief at critical times—was also good for the general public. At the same time, this policy obviously acted as a welfare program for bankers. The Fed was the bankers' lender of last resort, but who was to say that the Fed was not also their lender of first resort?

The check-and-balance here was supposed to have been the real bills-eligible paper doctrine. This device, however, had proven demonstrably unworkable because of the pro-cyclical aura that commercial loans assumed: When business was good, all discounts were very, very "eligible"; and when business was bad, they were all horrid. Open market operations were the answer. Not only did they make the discounting function unnecessary, they also could be conducted by an "impartial" body—the Federal (Reserve) Open Market Committee (FOMC).

The debate on this issue provoked a discussion over which elements in the System should have, and which did have, decision-making powers—the Board or the Federal Reserve Bank of New York. The debaters were Senator Glass and Senator Elmer Thomas, a populist from Oklahoma.

"The Federal Reserve Board," said Thomas, "should be the most powerful, the most important, and most respected tribunal in the

[2]Glass's statement implies this view. The Federal Reserve Banks were *banks*, albeit of a special kind, but operating under some of the constraints of private ownership.

United States." Unfortunately, he noted, the Board did not control the Federal Reserve System. Rather, "the policy of the 12 banks is controlled and dictated by the Federal Reserve Bank of New York." Glass denied Thomas's statement as "... inaccurate ... [and] a humiliating confession that the Federal Reserve Board ... declined to assert its lawful functions.... The Board was instituted to see that the Federal Reserve Banks obeyed the law." Thomas replied: "Heretofore, the Federal Reserve Board has been so circumscribed with limitations that [it] had virtually no effective power." Glass countered: "They had all power" (*CR* 79, pt. 11 [1935]: 11923–24).

The blind men were describing the elephant. Each had a different view of who ought to control the system, who did control the system, and how the system was supposed to work in the first place. This uncertainty over the Fed's structure and functions was the logical result of public bureaucracy. It is discussed in picturesque detail in Friedman and Schwartz's *Monetary History of the United States*. Particularly emphasized by them, and also by the debates in Congress, was the cult of personality. They argue with much force that the effectiveness of policy within the framework of the System at that time depended on the force of personality in those men who knew how the monetary system worked (Friedman and Schwartz 1963, pp. 411–19). Ironically, this characteristic is just what the original Federal Reserve Act was supposed to avoid.

The cult of laying on hands, however, was rampant in the 1930s. Steagall's categorical remark cited above is a case in point. In the Senate the same idea was belabored by Elmer Thomas in his exaltation of the Federal Reserve Board. "Someone, somewhere," he asserted, "has been and is regulating the value [of money]; and I should like to inquire under what law is the value of the dollar being regulated?" The Constitution, he noted, granted Congress the power to regulate the value of money. The dollar had doubled in value from unknown causes between 1920 and 1935. "Someone," he continued, "is regulating the value of our dollar. No one seems to know who is doing it. There is no authority, there is no commission, there is no board, there is no particular individual who has had enjoined upon it or him, by congressional mandate, the duty of regulating the value of the dollar." His prescription was that the Federal Reserve Board be "charged with this responsibility" (CR 79, pt. 11 [1935]: 11925).

Senators Gerald Nye of North Dakota and William Borah of Idaho also wanted to implement Congress's power to regulate the value of money. They proposed writing into the new bill a section prescribing a stable price level policy to be implemented by the Federal Reserve Board. Indeed, Nye wanted the Board's staff to include the Bureau

of Labor Statistics so that the Board could "scientifically and accurately determine the rate at which progressive additions to the stock of circulating money . . . must be made in order to maintain an even and stable purchasing power" (*CR* 79, pt. 11 [1935]: 11842).

Borah was even more explicit in his wish to avoid discretion. He warned against the open-ended nature of the open market provision stating, "There is practically no limit there—nothing but the discretion of such men as [Benjamin] Strong and [John] Mitchell." He wanted Congress "to fix a definite policy and enact a definite mandate by which these officers . . . are to be controlled" (*CR* 79, pt. 11 [1935]: 11908). The proposed amendments, however, were rejected by a voice vote of the Senate.

A final element in the bill was to take the Secretary of the Treasury and the Comptroller of the Currency off the Board. They had been included as *ex officio* members in the original act. Glass, who had been Secretary of the Treasury under Wilson, rendered a telling commentary on this provision. He observed that as Secretary he had treated the Board "as a bureau of the Treasury. . . . I dominated the activities of the Board," he confessed, "and I always directed them in the interests of the Treasury, and so did my predecessor, the present Senator from California [Mr. William McAdoo]" (*CR* 79, pt. 11 [1935]: 11776). Even in the beginning, the much-vaunted political independence of the Fed was a myth.

IV. The Federal Reserve System after 1935

The Banking Act of 1935 took the Secretary of the Treasury off the Board, but it did not take him out of range for influencing Federal Reserve policy. This policy during the late 1930s and through the 1940s shifted from the old eligible paper principle to the political compulsion of chaperoning government security prices and their corresponding interest rates. Here again the heavy hand of the Executive Branch was manifest. Only after Marriner Eccles, a more independent member of the Federal Reserve Board, openly challenged the brazen attempt by the Truman administration to continue the government security policy did Congress insist that the Treasury abstain from any further interference with the Fed (Eccles 1951, pp. 479–99).

The "Accord" between the two agencies was reached in 1951. From then until the mid-1960s, the Fed as an institution did nothing blatantly exceptionable. Money stocks increased conservatively, and the rate of change in prices was very close to zero for fifteen years.

Two independent events brought this stable and tranquil era to a close. First, the fiscal spending programs of the Johnson administra-

tion put much direct and indirect pressure on the Fed to inflate the monetary system. The Fed, unable to resist, let the monetary aggregates increase unduly and the price level began to rise. For the next 15 years—from mid-1967 to about 1982—money stocks and price level fluctuations behaved similarly to a remorseful but irresolute alcoholic and his bottle. A period of monetary drunkenness would be followed by a weeping and wailing and gnashing of teeth and a return to monetary austerity. Then rationalizations would appear: "High interest rates are hurting the fragile economic recovery." "The agricultural sectors (or the smokestack industries) are depressed." "We need monetary relief from ______." (Here, the reader can furnish his favorite scapegoat policy, such as "monetarism.") With a happy gasp, the bottle would appear again.

The other happenstance of the time was the flow of gold from the United States to foreign central banks and governments. The only technical effect this movement had on the monetary system was to change the Fed's accounting and monetization procedures. When the Fed lost dollar values in its gold certificate account, it replaced them by monetizing more government securities. This compensation emphasized the insularity of Fed policy from the discipline of gold movements. Nonetheless, the Fed's reserve ratio requirement of gold certificates to the high-powered money it created was threatened by the loss of gold. Congress, at the urging of then-President Johnson, thereupon abolished the gold constraint—first, against bank reserves in 1966, and against Federal Reserve notes in 1968.

The Fed had always had an escape route from the gold requirement (Board of Governors 1961, sec. 11, 4, pp. 34–35). However, Fed officials embraced it as a legal buffer between themselves and politically inspired monetary foolishness. Without it, they had only Congress's enjoinder to promote reasonably stable prices and high levels of employment and production consistent with and in support of the Employment Act of 1946. This doctrine is poor defense against monetary excesses because it is too vague and because it suggests more than monetary policy can deliver. "High levels of employment," for example, can be shaken in the faces of Fed managers to such an extent that they abandon the realizable goal of price level stability in a vain attempt to further this more popular political nostrum. With the gold rule in place, they could resist more effectively.

V. The Monetary Control Act of 1980

The complete abandonment of gold reserve requirements left the Fed without even technical constraints over its money-creating

powers. Consequently, inclusion of the monetary control section in the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980 is somewhat puzzling. If a regulatory agency already has absolute power, why does it need enhancement of such power? Additionally, if the private financial industry is deregulated, would not this change suggest, as well, a complementary reduction in the regulatory power of the controlling agency?

The DIDMCA has in total eight titles, which deal with truth in lending simplification, state usury laws, amendments to the national banking laws, and other matters. The first two titles, however, contain the principal substance of the act as well as its contradictory implications: Title I greatly extends the Fed's powers and regulatory scope. At the same time, Title II significantly relaxes restrictions on freedom of economic activity for the rest of the banking and financial system.

Most of Congress's legislative energy was spent on Title II, the section of the act that provided for limited deregulation of the financial industry. The steps taken therein had much theoretical and practical evidence to support them. Title II allowed nonbank institutions to issue deposits, and it permitted banks to offer interest payments on their demand obligations. All institutions could then compete on a "level playing field." Title II also provided for the phasing out of Fed ceilings on interest rates paid to depositors. The obvious logic of these provisions was reflected in the overwhelming vote by which the act was passed in late March 1980 (*CR* 126, pt. 6 [1980]: 7073).

Title I, however, is a different story. In the hearings and debates over this section, Federal Reserve officials presented both Houses of Congress with an array of arguments that dealt largely with three non-problems: (1) The "problem" of declining Fed membership by commercial banks; (2) the "problem" of Federal Reserve note collateral; and (3) the "problem" of Treasury revenue from the Federal Reserve's seigniorage powers. The Fed's preoccupation with these "problems," and its political strategy in resolving them in ways that redounded to its own power and prestige, show how far its present institutional image has departed from the original Federal Reserve Act.

The "problem" of declining bank membership in the Fed (2 per cent of the total between 1970 and 1978) has always been an issue on which Fed officials have spared no rhetoric. Their favorite solution—that Fed membership be made mandatory for all depository institutions—appeared again in their testimony in support of the DIDMCA. Both past and present Fed chairmen of the Board of Governors—Arthur Burns, G. William Miller, and Paul Volcker—

appeared before congressional committees and testified positively on this issue.[3] Without control over bank reserves deposited in Federal Reserve Banks, Volcker argued before congressional committees, the Open Market Committee would not have a "fulcrum" with which to promote monetary policy (*FRB* 65, no. 10 [1979]: 823).

Volcker's words were noted by Representative Henry Reuss of Wisconsin, who echoed them to his House colleagues a few months later. "Unless [the monetary authorities] have a 'fulcrum,' . . . a reserve base upon which they can conduct their open market policy," Reuss stated, "they are incapable of regulating the money supply" (*CR* 125, pt. 15 [1979]: 19689).

Former Chairman G. William Miller tied reserves and membership to the privilege of the discount window. In a statement that is classic for its inconsistency, he first noted the Fed could indeed check growth in money and credit to abate inflation. He then argued that if bank membership in the Fed declined significantly so that fewer and fewer banks had access to the discount window, the Fed "may find that its ability . . . to curb inflation was being unduly impeded because the safety valve provided by the discount window was losing its effective coverage" (*FRB* 65, no. 3 [1979]: 230).

These statements by Fed officials were either contradictions of facts or palpable absurdities. The Fed creates the monetary base in the form of bank vault cash, hand-to-hand currency, and bank reserve accounts constantly and positively, not just when an occasional bank needs extra liquidity. Virtually every hour of the day the Fed is acting as a "lender of last resort" by converting government securities into the monetary base, which banks must hold as reserves whether they are Fed members or not. In this ongoing operation, the role of the discount window is negligible. The dollar value of the monetary base at the end of 1980, for example, was $155 billion, while loans to member banks were less than $1.5 billion. Therefore, as a source of the monetary base, Fed monetization of discounts to member banks was less than 1 percent.

Federal Reserve arguments on the second non-problem—the alleged inadequacy of government security collateral for "backing" Federal Reserve notes—proved to be a panoply of accounting absurdities and subterfuge. In order for the Fed to issue Federal Reserve notes, it must buy one of a number of financial assets that already are eligible collateral. Therefore, it could never be short of such items.

[3]See *Federal Reserve Bulletin* 65, no. 3 (1979): 230, and *Federal Reserve Bulletin* 65, no. 10 (1979): 823. Hereafter, all references to the *Federal Reserve Bulletin* are abbreviated by *FRB*.

Notwithstanding the facts of the balance sheet, Fed officials argued that the list of collaterals needed to be supplemented by the inclusion of "fully guaranteed obligations of a foreign government or the agency of a foreign government." The Fed not only initiated this provision by contacting key members of Congress who wrote the act, they also supplied the devious arguments to support it (*FRB* 65, no. 10 [1979]: 822–28). In their testimony, Fed officials inverted the entire money-creating procedure for the benefit of their congressional puppets. When Senator Proxmire discussed Fed procedures and the necessity for collateral supplementation before his Senate colleagues, his "explanation" came out as follows: "A portion of the Federal Reserves securities portfolio," he said ". . . represent[s] purchases made [by the Fed] with reserves *deposited by member banks*. Since the Monetary Control Act would release [sic] about $15 billion in reserves [due to lower reserve requirements], a comparable amount of securities would need to be sold. This would reduce the collateral available for Federal Reserve notes" (*CR* 126, pt. 6 [1980]: 6897; emphasis added).

A similar explanation was presented in the House by Chalmers P. Wylie of Ohio. "The banks hold some of these reserves [created by open market operations] as vault cash," he said, "and the rest goes *into* the Federal Reserve System which it uses for investments—the return from which goes to the Treasury of the United States (*CR* 125, pt. 15 [1979]: 19669; emphasis added).

The Proxmire-Wylie (nee Volcker) "explanation" of money-creating procedures implies that the commercial banks initiate the process. As everyone acquainted with Fed operations knows, the FOMC initiates the purchase of the securities and perforce creates bank reserves or currency for which the securities serve as collateral. The Fed can never be short of collateral for the monetary base because it must create the base items to buy the collateral securities.

Actual experience since the passage of the DIDMCA indicates that no collateral problem arose (as, indeed, it *could* not.) The Fed Banks' consolidated balance sheet during the 1981–84 period never showed less than an excess of $9 billion in conventional collateral (i.e., without foreign currencies or obligations) over the outstanding issues of Federal Reserve notes.

The only possible reason for Fed officials to have cultivated this fictional account of their procedures was to extend the Fed's authority for bailing out foreign governments that had outstanding loans with some influential banks in the United States. It could not have had anything to do with the propriety or sufficiency of Federal Reserve

note collateral, or with the support of the commercial banking system, or with the Fed's maintenance of the monetary system.[4]

The third non-problem treated was the anticipated decline in Treasury revenues that would occur if the Fed tried to solve the non-problem of declining membership by paying depository institutions market interest rates for the reserves they kept in Federal Reserve Banks. Such a provision would have eliminated the real problem member institutions faced in holding these zero-interest reserve balances, and would have been an almost certain means for attracting as many new members as the Fed thought desirable. Since the number of members does not determine the Fed's monetary control factor, it would not have extended the Fed's policy powers. However, it would have answered the Fed's arguments with respect to the relationship between membership and control.

Both G. William Miller and Paul Volcker, on different occasions, commented on this issue. Volcker noted that the costs *to the U.S. Treasury* of paying interest on reserve balances "would be relatively high—apparently higher than the [Carter] administration or Congress would find tolerable" (*FRB* 65, no. 10 [1979]: 824). And Miller several times in his testimony commented on how this or that change in Federal Reserve operations or procedures would impinge revenues to the Treasury (*FRB* 65, no. 3 [1979]: 234–35).

The "problem" of revenue losses to the Treasury stems from the fact that the Fed is the U.S. government's principal minting operation. Every year Fed purchases of U.S. government securities through open-market operations add an equivalent dollar amount of high-powered money to the economy. During calendar year 1984, for example, the Fed bought around $15 billion in U.S. government securities making its total monetization of securities $165 billion. This amount, minus the trivial costs of accounting the new money or printing it, are real seigniorage revenues the government derives from the Fed, its money-creating adjunct. The securities are accounted as if they would receive interest returns from the Treasury. Federal Reserve costs are then deducted from this "income," and the balance is "rebated" to the Treasury. In 1983, net "income" on Fed holdings of U.S. government securities after costs was accounted as $14 billion and duly "returned" to the Treasury (*FRB* 70, no. 2 [1984]: 109).

In fact, none of this net interest "income" ever gets to the Federal Reserve. The Fed's budget—that part of its government security "income" actually paid from Treasury revenues—appears to the

[4]These two "problems" are discussed in somewhat more detail in Timberlake (1985, pp. 97–102).

Treasury Department as a net drain on general revenues, and any addition to the Fed's budgetary outlays is seen by the Treasury as an additional cash outflow and cost for servicing the national debt. Therefore, interest payments on the reserve balances of depository institutions would not have reduced Federal Reserve "income," but would have increased Federal Reserve costs—and Treasury payments—in 1980 by an estimated $500 million. These outlays would have gone to the depository institutions who kept reserve accounts at Federal Reserve Banks.

Chairman Miller noted in his testimony that the estimated aggregate cost of Fed membership to the member banks exceeded $650 million annually in 1977 (*FRB* 65, no. 3 [1979]: 231). Provision for interest payments, in all fairness, would simply have offset this real cost to the banks and would have made the banks more competitive with their nonbank rivals. Finally, it would have retained the voluntary character of Fed membership.

These arguments notwithstanding, Volcker, while he paid lip service to a voluntary system, urged mandatory and universal reserve requirements. "This approach," he said, "is consistent with the position preferred by the Federal Reserve Board for a long time" (*FRB* 65, no. 10 [1979]: 824). Just as important, this approach was the only one that the Treasury and the Carter administration would accept. They were not about to forgo any of the lucrative seigniorage revenue that comes to the government without legislation or any popular awareness of its existence.

VI. What To Do with the Fed

The non-problems emphasized by the Fed in 1979–80 are important because they underline the priority of the Fed's institutional concerns, which are: (1) to extend the scope of its imperial control over the entire financial industry; (2) to extend its ability to undertake security purchases in foreign financial markets; and (3) to continue to act as a seigniorage agency for the federal government.

These concerns are in sharp contrast to the original arguments for the Fed's existence and the policies it was authorized to undertake. In the beginning, it was an institution designed: (1) to accommodate commercial banks on only a seasonal and emergency basis; (2) to do so by the self-regulating efficacy of the real bills principle and the discount rate it charged member banks; (3) to be completely independent of, and unsullied by, political immoralities; and (4) to carry out its operations within the framework of a gold standard.

The acts of 1935 and 1980 formally changed the Fed—from a system in which the Federal Reserve Banks were autonomous and the Federal Reserve Board a refereeing committee, to a System in which the Board in Washington is all powerful and the Federal Reserve Banks not much more than administrative units; from an occasional discounter of real bills at the initiative of member banks, to a constant and heavy monetizer of government securities at the initiative of the Open Market Committee; from an institution specifically subordinated to the gold standard, to one that has a monopoly on the initial creation of money, with no vestige of a gold standard remaining; from a lender of last resort for banks, to a perpetual motion machine of money creation; from an institution with an avowed interest in providing liquidity in support of sound banks, to one whose every act is to enhance the power and prestige of itself and the government. Unless one can argue that what is good for the government is good for the general public, one cannot defend either the mutation of the Fed as it has occurred, or the Fed's continued existence as an all-powerful central bank. Its 70-year history as a bureaucratic institution confirms the inability of Congress to bring it to heel. Whenever its own powers are at stake, the Fed exercises an intellectual ascendancy over Congress that consistently results in an extension of Fed authority. This pattern reflects the dominance of bureaucratic expertise for which there is no solution as long as the specialized agency continues to exist.

The Fed's technical superiority notwithstanding, it is itself extremely vulnerable to the political pressures of the executive branch. (The remarks of Carter Glass and Marriner Eccles cited above are only two of the more dramatic examples of Treasury intervention.) These elements together result in a central bank with unlimited control over the monetary system. While it is advertised as an enabling agency for Congress, in practice the Fed is dominated by any strong-willed executive who covets the power of the purse as well as the power of the sword.

The FOMC makes all present-day decisions concerning the creation of money. While it uses the open market account manager at the Federal Reserve Bank of New York as its operational arm, the 12 Federal Reserve Banks as such have virtually no part in the money-creating process. Their existence does nothing more than provide an accounting statement in which the purchase of securities can be credited and the monetary base items debited. This entire operation could be managed in a building the size of a corner grocery store.

While the 12 Federal Reserve Banks are superfluous facades for the creation of base money, they are still valuable resources for the

payments system. In this role they could function efficiently as private enterprises. Therefore, all the Federal Reserve Banks, branches, research centers, and appurtenances should be completely divorced from the government and placed in the hands of their stockholders. The "member banks" in name would become member banks in fact. They would administer the Federal Reserve Banks as clearinghouse associations, just as they managed their own clearinghouse organizations during the latter half of the 19th-century, and they would provide themselves with deposit insurance schemes according to their perceived needs. They would charge fees for their services to the banks that wanted such assistance, and would thus cover their costs. Having a source of income as private enterprises, they would no longer be a fiscal burden to the U.S. Treasury.

This proposed change is in part already taking place. The DIDMCA of 1980 requires the assessment of fees for many Fed services, billed to the depository institutions' accounts. Privatization would simply extend this practice to all bankers' bank services and make the whole industry a bottom-line enterprise. Since the bankers would own and operate their bankers' banks, they would have a self-interest in economizing the system's operations—the element Senator Glass found lacking in the Federal Reserve Board during the debates over the Banking Act of 1935.

Privatization of the 12 Federal Reserve Banks and their branches would still leave the money creating powers of the Board and FOMC untouched. These powers center on the control of the monetary base, which largely determines the conventional money stocks M_1 and M_2. Important for current policy is the growth rate in these stocks. The evidence is conclusive that a growth rate of the monetary base and the other money stocks greater than the growth rate in real product generates inflation and a corresponding misallocation of resources, without contributing any compensating benefits to the economy. A rate of growth in money between 0 percent and (say) 4 percent does not result in any measurable inflation, but it still allows the federal government to realize seigniorage revenue through its monopoly power to create money. The only way to reduce this seigniorage tax to zero is for Congress to proscribe any further increase in the monetary base. The base should be frozen at its present level and maintained there forever through routine procedures of the FOMC.

The results of this policy, which should be implemented very gradually but consistently, would likely be a long-run decline of prices (after a transition period) by an amount equal to the rate of growth in real product.[5] This rate of price level decline would be an

[5]Transition to a frozen base program in a way that would avoid significant social costs

explicit quasi-interest rate for money held as cash balances. It would provide money holders with a bounty in proportion to the amount of money in their possession, so it would be similar to a negative tax. The economy's real stock of money, that is, the frozen nominal stock adjusted for the change in the value of the money unit, would increase by the rate of growth in real product (which would also equal the rate of decline in money prices). This appreciation would be the private sector's proxy income for what is now government seigniorage revenue.[6] Households and business firms would then have an incentive to hold money as it accumulated for routine disbursements, such as payrolls, rather than use untold amounts of real resources churning money into and then out of short-term interest-bearing money market accounts.

What are the economic disadvantages of a reasonably certain steady-state decline in prices? In the light of both history and theory, very few if any. Real economic growth in the United States between 1870 and 1897, when the price level declined at a rate of about 1 percent a year, was as great as, or greater than, growth in any comparable period in U.S. history (Friedman and Schwartz 1963, pp. 87, 93).

The argument from theory is based on the applicability of Phillips curve analysis, that is, the effect of the inflation rate on the level of employment. The evidence is that the long-run Phillips curve is perfectly inelastic: The rate of inflation has no long-term impact on the level of employment (Humphrey 1982, pp. 73–93). Therefore, a long-run declining price level has no employment disadvantages but has the resource allocation efficiencies already noted.

The desirability of a frozen base from a polity standpoint is equally compelling. The habitual uncertainty necessarily posed by the human discretion of the Fed Board of Governors and FOMC would disappear. This uncertainty requires, again, real resources for its minimization. The variable policies in practice have also proven highly costly to various sectors of the economy—for example, to the savings and loan associations during the 1970s and early 1980s.

Freezing the base has the final practical advantage of not requiring a complete restructuring of the existing monetary system. Federal

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requires separate treatment. All I deal with here is long-run equilibrium after money creation by the Fed has been scaled down to zero. The transition phase poses some challenging questions, but none that is insurmountable.

[6]The proposal for a zero-growth money stock is the policy side of Milton Friedman's "optimum quantity of money" argument (Friedman 1969, pp. 1–48). His analysis also anticipates a decline in velocity of about 1 percent a year, which is realistic for the transition period but not necessarily for a long-run steady decline in the price level. See also his proposal for freezing the monetary base (Friedman 1984, pp. 48–51).

Reserve notes would still be legal tender as vault cash and hand-to-hand currency, and bank reserve accounts at the now-privatized Federal Reserve Banks would still serve as interbank clearing media and be convertible into Federal Reserve notes. The FOMC would continue to manage these base accounts in such a way that the total base would remain constant.

Throwing out completely the current payments system would serve no good purpose. Any damage the Fed has imposed on market participants has already been capitalized. Therefore, substituting a completely new system for the present one would be analogous to throwing away a useful capital structure simply because it was managed improperly.

The transition from a government managed monetary system to one organized by private enterprise in a market environment could be aided by one more reform—a true *beau geste:* privatization of the Treasury's stockpile of gold, which amounts to approximately 8,740 tons. This gold could be systematically sold off at auction as a means of covering current fiscal deficits, or it could be popularly distributed to the citizens of the United States on a per capita basis (approximately one ounce for each man, woman, and child in the United States). Such a distribution has precedent in an act of this very kind that took place in 1837 (Timberlake 1978, ch. 5, pp. 50–62). To make the current distribution even sweeter, the titles to the gold, redeemable into gold coins on demand, could be emitted as quasi-receipts by the IRS in acknowledgment of income taxes paid. People could then hold or dispose of the gold as they pleased. Some would convert it into gold ornaments or sell it to industrial users.

Many people who wished to retain ownership without paying the forgone cost of holding a "useless" substance would deposit their gold receipts as gold-based accounts in banks. The gold would not need to be assigned a dollar value; it would not become *the* standard. Its market value would be established in terms of demand and supply relative to the now-frozen stock of conventional money. Once an equilibrium price of gold appeared—in what I would suggest would be a very short period of time—gold could act as the growth element in the money supply, much as it did in the days of the gold standard. Its use as money, however, would not preclude the use of other competing monies that might arise through innovation in the money industry, nor necessitate disuse and abandonment of current conventional money.

All the ramifications that would follow from such a wide distribution of gold are not immediately inferable. However, I fail to see how they could be harmful. While gold, now widely distributed, might

tend to fall in price because of the great increase in its marketable supply, its probable widespread use as money would also tend to raise its price. In any case, households in the economy would now own the gold. They would no longer be taxed by a money-creating central bank nor be subjected to the vagaries of policy practiced by that same institution.

The passage of time has blunted a general understanding of the Fed's original mission as well as the limited scope it was allowed for policy operations. Freezing the monetary base, privatizing the Federal Reserve Banks, giving the commercial banking system freedom to develop a competitive monetary market, and unblocking the U.S. Treasury's nonfunctioning gold stock would undo much of the harm that has befallen the monetary system since it was unwisely saddled with a central bank overseer. It would restore a freedom that was never intended to be violated.

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THE FED AS AN INSTITUTION

David I. Fand

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 clear-

inghouse 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).