

ECONOMICS USA

PROGRAM #21

THE FEDERAL RESERVE: DOES MONEY MATTER?

AUDIO PROGRAM TRANSCRIPT

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(MUSIC PLAYS)

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FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK STASIO: Economics U\$A. One of the series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Monetary Policy and the Federal Reserve System. Our guest is Phillip Cagan, Professor of Economics at Columbia University, and visiting scholar at the American Enterprise Institute. I'm Frank Stasio.

(VARIOUS COMMERCIAL CLIPS)

FRANK STASIO: When banks compete for our business, they like to stress their convenience and their interest in the local community. But, most important, banks want to convince us that our money is safe. Words like "security" and "guarantee" are often part of the bank's name. A hundred years ago, banks were risky places for people to keep their money. Until the early part of the twentieth century, banks failed often and depositors regularly lost their savings. Our assurance about the banking system comes as the result of the Federal Reserve System, established in 1913. Six years earlier, in 1907, a run on the Knickerbocker Trust in New York City led to a nationwide bank panic. Nearly two hundred fifty banks were closed as a result. Phillip Cagan teaches economics at Columbia University, and is a visiting scholar at the American Enterprise Institute. Doctor Cagan says that the Federal Reserve Act, which created a

central bank made up of twelve regional banks across the country, was an outgrowth of the panic of 1907.

PHILIP CAGAN: “Well, it...it grew out, in the sense that Congress had been thinking that something had to be done about these periodic panics. And uh, it galvanized them to hold hearings. There was much discussion in Congress. Didn’t happen right away. The Federal Reserve Act was passed in 1913, which, is quite a few years after the panic of 1907. But there was a lot of activity all during that period directed towards this, and it finally came to fruition in 1913. And uh, the next year, 1914, the first Federal Reserve banks were established, just in time, as it is said, to handle the financing of World War I, a purpose that it was not originally designed for.”

FRANK STASIO: While the need for a central bank had been clear for some time, there had always been a fear among bankers, farmers, and businessmen outside of the Northeast, that the central bank would be dominated by Eastern banking interests. So, the Fed was split into twelve regions. Historian and economist, Lester Chandler.

LESTER CHANDLER: “Within the Federal Reserve System, nobody knew who was to do what, at least as far as the Federal Reserve Act was concerned. They turned down the Aldrich Plan for one central bank with branches, and adopted a system with twelve independent banks. And, then, on top of that, they put a Federal Reserve Board that was forced to do something centrally, but, uh, they couldn’t decide who was to do what.”

FRANK STASIO: That confusion would create major problems when the Federal Reserve System would face its greatest challenge, during the Great Depression, some sixteen years after its creation. As Chandler said, the Federal Reserve banks are often overseen by a board of governors called the Federal Reserve Board, or, the Fed. The seven members of the Federal Reserve Board are appointed by the President to serve 14-year terms. At first, the Fed was given a limited mission.

PHILIP CAGAN: “The major provision of the Federal Reserve System, when it was set up, was to provide extra reserves to the banking system at a time of need in order to prevent these panics from closing down the system. The idea being, that, if you could give the banks, temporarily, more reserves. in order to meet these panicky demands on them, as soon as the public saw that the banks were able to give them all the currency that they wanted when they went in to withdraw their deposit, they would see that the banks were liquid. And at that point, knowing they can get their money, they wouldn’t want it anymore. So, the panic, uh, would be over, presumably. And the mechanism for handling this was to provide the banks with more reserves temporarily, and the...and the way to do this was for the Federal Reserve, which had the authority to create reserves, to lend it to the banks, uh, whenever they needed it. So, this was done through the banks borrowing from the Fed, and they did it through a process that was called “discounting commercial paper.” So, it came to be known as “the discount rate.” But what it is, is the interest rate that the Federal Reserve charges the banks when they lend them money. The idea is not that you just give the banks the money for nothing. The banks have to pay for it. But, uh, it would be done on a basis of, uh, providing them with the extra reserves that they need to handle these, uh, special with uh...uh, panicky situations.”

FRANK STASIO: The Fed was also charged with handling the nation’s financial transactions. It collects checks, allowing banks to collect funds for checks drawn on other banks. It issues currency, holds some of the checking accounts of the U.S. Treasury, and it supervises the operation of member commercial banks. But, perhaps, the most important function of the Federal Reserve System is to hold the deposit or reserves of member banks by managing the reserves of the banking system. The Fed has the power to influence the total supply of money. For instance, the Federal Reserve can adjust the interest or discount rate that banks pay to borrow money from the Fed.

PHILIP CAGAN: “In the early days of the Federal Reserve System, they would, uh, lend rather freely to the banks and, therefore, the banks might be encouraged to borrow more if the discount rate were low than if it were high. And this would be true over the business cycle, not only in periods of panic, but the banks would come to the Federal Reserve to borrow if they thought that the amount of reserves that they could borrow uh, would uh, be good for their business if,

depending on the rate that they would pay the Federal Reserve and the rate that they would receive when they made loans. So, the discount rate uh, was viewed as a...as a mechanism for...for regulating the amount of borrowing that the banks would do. So, obviously, if the discount rate were raised and the banks had to pay the Federal Reserve more for reserves, this would mean that they would have to charge their customers more, and this would tend to raise the interest rate throughout the economy. The higher interest rate for borrowing would mean...discourage some borrowing and this would discourage uh...uh, investment expenditures and aggregate demand throughout the economy.”

FRANK STASIO: Along with the discount rate, the Fed has other tools for meeting its monetary goals. One way the Fed influences the money supply is by setting the amount that reserves banks must keep on deposit at any one time. This is called the “reserve ratio.” By raising the reserve ratio, the Fed forces banks to keep a greater proportion of assets in the bank, meaning the bank can lend less money. But, in its early days, the Fed tried not to interfere with the money supply, and saw itself mostly as the lender of last resort for member banks. It worked well enough for a while, but, then, in 1929, the bottom began to fall out of the economy. The Great Depression. Thousands of banks went under as panicky depositors rushed to withdraw their cash. This left the banking system as a whole with less money to lend, practically strangling the economy.

PHILIP CAGAN: “There’d been a series of, uh, blows to the banking system because of, uh...uh, major banks that went under. And the public was becoming increasingly concerned about the safety of the banks. This was coupled with the decline in the economy, which was uh, causing uh, depression in the agricultural sector. So, many banks which made agricultural loans were in severe difficulty, so, there was good reason to be concerned about the banks. We had a series of banking runs, then, through the early 1930s, in which people decided that it wasn’t safe to have their money in the banks. So, they went to the banks and took, converted, their deposits into currency. If you look at the data, this shows that the amount of currency that people were holding relative to their incomes, and to their deposits, and to other measures that you might use, was rising very rapidly, and, therefore, was an indication that the banks were under severe pressure. The banks responded to this loss of currency, which was a loss of reserves for them, by

constantly being forced to contract. They couldn't make the same volume of loans that they did before. So, the volume of deposits tended to go down because the banks were not expanding their loans. And, at the same time, they were losing reserves in the form of currency. The Federal Reserve has been criticized for what they did during this period, which was not sufficiently to provide the banks with enough reserves, so that the, uh, that they would be have to contract their deposits. The net effect was, given the fractional reserve banking system, this conversion of deposits into currency meant that the total quantity of money, adding up currency and deposits, went down because, while the currency was going up, deposits were going down even more, in a multiple way."

FRANK STASIO: Why didn't the, uh, Fed respond the right way?

PHILIP CAGAN: "It's a lot of disagreement about, and a long story about what was happening to the Fed at that time. There were certain political struggles going on. There was disagreement within the Fed, but there was a pervasive notion at that time that the Federal Reserve could not directly influence the economy, that its job was to react to what was going on in the economy. There were many people in the Federal Reserve System, as they saw the economy contracting, who felt that the money, the economy, did not need as much money, and, therefore, it was appropriate for the money supply to contract, along with the economy. Many of us feel that this is a misinterpretation of what was happening because it did not take into account the fact that, as the money supply contracted, this added a contractionary pressure on the economy. And, indeed, the contractionary in, uh...uh, path could have been reversed if the Federal Reserve had thrown a lot of liquidity, a lot of extra money into the economy and made it much easier for the banks to make loans at that time. But there was a feeling that...that by...by pushing reserves into the economy that it didn't seem to need, that this, uh, created an overly liquid situation. And there was fear that this was bad for the economy."

FRANK STASIO: Today, it is generally believed that, if the Fed had worked against the business cycle, using its monetary tools to pump money into a contracting economy, that the effects of the Great Depression would not have been as severe as they were.

PHILIP CAGAN: “So, it’s long been felt that the money supply should not contribute to the business cycle by fueling the expansion and contracting and holding back on the recession, but should actually be a...a stabilizing influence. The stabilizing influence would come if, as the economy tends to expand in the upswing of the business cycle, if the money supply did not expand so rapidly during that time, it would tend to be a constraint on the expansion of the economy. And this is, uh, felt that this constraint would prevent the, uh, business cycle from going too far and leading to a recession on the uh, on the downside. Then, if for any reason, the economy does go into a recession, the hope was that the, an expansion of the money supply, then, would tend to stimulate the economy and counteract this uh, recessionary influence. Now, the banks operating on their own will tend to expand and contract with the economy because business loans tend to go up and down as business activity goes up and down. So, only through a central bank, which could step in and constrain the banks from expanding on the upside, encouraging them to expand on the downside, would be able to counteract this business-cycle pattern.”

FRANK STASIO: But it can also be argued that, even if the Fed had tried to increase reserves, banks would not have let out any more money.

PHILIP CAGAN: “There are two explanations for this. One is that they didn’t see the opportunities for making loans that they would otherwise like to make. Interest rates were very low, and they, uh, felt that holding the extra money was...was a safer thing to do then lending at very low interest rates. But they were also afraid. The Federal Reserve had failed them in the early 1930s in a way that they had thought, uh, they would be saved. And, so, the banks were very skittish, very nervous uh, following the banking panic of 1933, and their reserves rose to very high levels. And many of us who’ve studied that period have argued that these were not excess reserves in the sense that there was nothing that the banks could do with them, but were actually desired reserves that the banks wanted to have, uh, because of the terrible experience they had in the... early 1930s. Many of them went under. They had difficult times. It was a very precarious time for banking, and they were very skittish for many years after that.”

FRANK STASIO: The Banking Act of 1935 added to the monetary remedies available to the Fed. The most important feature of the Act was the creation of the Federal Open-Market Committee. The federal government, through the Treasury Department, finances many of its operations through the sale of securities, like war bonds during World War II.

MALE VOICE: “Buy defense bonds and stamps, today and every day.”

FEMALE VOICE: “Buy United States War Bonds and stamps.”

MALE VOICE: “Put every dollar you can into defense bonds, sold by any bank, post office, or savings and loan association.”

FRANK STASIO: The Fed is directly involved in the purchase and sale of government securities through its open-market operations. These operations have considerable influence over the money supply. Open-market operations are governed by the Federal Open-Market Committee, a twelve-member panel, made up of the seven members of the Federal Reserve Board and five Federal Reserve Bank presidents, selected on a rotating basis.

PHILIP CAGAN: “It is the monetary policy operating board of the Federal Reserve which decides, uh, what their monetary policy should be. That is, uh, how the open-market operation should be conducted primarily. They get together every three or four weeks to take a look at the economy, decide whether a little bit more stimulus or a little bit less stimulus is appropriate at the time, and then give directions to the, uh, person who, uh, manages the open-market operations, which is the, uh, which is conducted by the Federal Reserve Bank of New York and the financial center of the country and by the open-market desk in the Federal Reserve Bank. So, that person and his staff receives from the Federal Reserve Open-Market Committee, regularly, directions on how they should conduct a policy, during the interval until the, uh, committee meets again.

FEMALE VOICE: “Okay, looking for offerings of all coupon issues for Thursday’s delivery, we want the propositions back by one o’clock.”

FRANK STASIO: Once they have their instructions, the eight securities traders working for the Federal Reserve Bank in New York make phone calls to private bond dealers and let them know they're interested in buying or selling securities. About a half an hour later, the transactions are complete, and the Fed has either raised or lowered the reserves of the banking system.

PHILIP CAGAN: "When the Federal Reserve buys securities from a bond dealer, uh, in the financial district, they pay for it by writing a check on themselves, so to speak, and this check is paid by reserves at the Federal Reserve. So, when the bond dealer deposits this check in his account at a commercial bank, the commercial bank sends the check to the Federal Reserve and receives reserves at the Federal Reserve. By this method of buying and selling Treasury bills and bonds, the Federal Reserve then controls the amount of reserves in the banking system."

FRANK STASIO: What is the Federal Open-Market Committee looking at when it tries to, uh, determine whether it should be buying or selling?

PHILIP CAGAN: "Well, of course, it's looking very much at what the economy is doing in terms of business activity and inflationary pressures. So, they will look at all the information they can get a hold of in order to get a...a...a handle on where they think the economy is going. So, they're concerned, of course, about moving the economy along a stable growth path without inflation. Well, we have business cycles, and we have inflation. So, obviously, they have not achieved their primary purpose. There's a lot of disagreement about how they should conduct monetary policy, whether they can do better than they have done or whether they're doing the best they can possibly do. The area of monetary policy is one of the most controversial areas in economics, and there's just, never seems to be any...any...any agreement about what should be done here. So, it's up to the Federal Reserve Open-Market Committee to distill this disagreement and come up with some sort of a policy. And, as you can imagine, there are many critics outside, second-guessing, and criticizing what they're doing."

ARTHUR BURNS: "Oh, sure, we could do more. We could do a lot more. We could even wreck this country, but we're not gonna do it, Senator."

FRANK STASIO: Former Fed Chairman, Arthur Burns, before a committee of the U.S. Senate. At least once a year, the Chairman of the Federal Reserve Board tells Congress about its general plans for growth in the money supply.

ARTHUR BURNS: “We may go further. Time will tell, but we will not open up the spigot and permit the money supply to increase rapidly because, if we did, in our judgment, we would not be helping significantly to relieve unemployment and we would be, on the other hand, releasing forces that could accelerate what is already a dangerous inflation.”

FRANK STASIO: The desire of Congress to place such a heavy emphasis on the money supply is, according to Doctor Cagan, a relatively recent phenomenon.

PHILIP CAGAN: “During the 1970s, Congress, uh, became under the influence of Monetarist ideas, which, uh...uh, are that...that the monetary policy should be conducted by targeting the growth of the money supply according to what would be best for the economy. Prior to that, the Federal Reserve would look at interest rates, and...and...and a variety of other things. Didn't pay that much attention to the money supply itself. So, Monetarist ideas had been developing for some time, and Congress persuaded, through what's called a...a 'Congressional resolution,' for the Federal Reserve to target or announce targets for the money supply, and, uh, to either, uh, follow these, or come back to Congress and tell them why they had... and forcing them to think in terms of monetary targeting.”

FRANK STASIO: The Fed, then, tries to meet those goals using various monetary tools, namely, the discount rate, the reserve ratio, and open-market operations. Open-market operations may also be used to meet short-term objectives. For instance, the open-market manager in New York may decide to add bank reserves on Fridays to handle the expected increase and demand for cash over the weekend. Likewise, it may increase bank reserves as the holiday season approaches. The presence of the Federal Reserve in the marketplace also has an effect on interest rates. Interest rates are simply the cost of money, and, according to the principles of supply and demand, the cost of money rises as the supply contracts. So, if the Fed sells securities, bank reserves shrink, and interest rates go up. Conversely, if the Fed expands

reserves by buying back government bonds, interest rates drop. Obviously, the Fed has enormous influence in financial markets, and so, Federal Reserve officers are careful about the way they make their intentions known.”

PHILIP CAGAN: “When the Federal Reserve generally enters the market every day, about eleven o’clock in the morning the, uh, financial uh, community is ready for this. They sort of stop and wait and see what the Federal Reserve is going to do in order to decide what they want to do, subsequently, in case the Federal Reserve is going to change, uh, the pattern that it’s been following. It can have an important influence on interest rates, and all the traders in the financial markets are very concerned with this. Then, beyond that, whether the people feel that the Federal Reserve is following a policy that will stimulate the economy or will restrain the economy is very important for financial markets, also. So, we have a whole group of people that are called ‘Fed watchers,’ who are assigned to try to dope out what the Federal Reserve is doing, and what the consequences of what they’re doing will be. Since the Federal Reserve does not want to give any special advantage to anyone in the market, they do not announce ahead of time what their specific operations are going to be. That is, if you knew that the Federal Reserve was trying to raise interest rates or lower interest rates in the market, as a speculator, you could make money by operating ahead of time. They don’t want anyone to have that advantage. So, they don’t say, specifically, ahead of time what they’re doing. They just generally make announcements about, uh, the general path that they want the economy to take. And, then, their open-market operations every day are conducted without any advance announcement, and, then, those in the market, then, day by day, notice what the Federal Reserve is doing, and respond to it.”

FRANK STASIO: And it shouldn’t be any real trick to figure out which way the Fed’s gonna go if...if you presume that you have the same data available to you as they do, and you pretty much know they’re trying to balance these cycles.

PHILIP CAGAN: “Yes, to some extent, you can, uh, dope out the general direction, but there will be details that you don’t know. The Federal Reserve may or may not decide that interest rates should be raised, may or may not decide that this is time to ease the economy, or if it is time to ease the economy, how much, and exactly how fast, they’re going to go. So, there is very

much an interest on the part of the financial community to dope out exactly what the Federal Reserve is going to do, and is doing.”

FRANK STASIO: From the very start, economists and policymakers saw the need to shield the Fed from short-term political pressures. That’s why the board members were given fourteen-year terms. Even so, the Fed has had to struggle to keep from becoming a tool of the political process. Up to the end of World War II, the Fed and the Treasury Department had a somewhat closer relationship than they do today. During the War, the Fed agreed to buy Treasury bonds to help finance defense spending. Andrew Brimmer is a former member of the Federal Reserve Board of Governors.

ANDREW BRIMMER: “As we entered World War II, the Federal Reserve undertook a commitment in January, 1942 to, uh...uh, support the market for government securities, meaning that it would buy and sell all the government securities anybody wanted to offer on the market uh, to keep interest rates from rising.”

FRANK STASIO: The Treasury Department liked the idea of having a guaranteed outlet for federal securities, and wanted to continue the relationship, even after the war. However, the Fed worried about the effects of continuing to pump so much money into the economy.

ANDREW BRIMMER: “As the economy began to expand after the war, uh, the demand for credit rose. Banks found an opportunity to lend to private companies, individuals, and so on. Where will they get the reserves? Where will they get the cash to do that? Sell your government securities. These are very low-yielding government securities, two and a half percent interest, two and three quarters percent interest, when you could lend, get, give, five, six percent, lending to private borrowers. So, the banks, insurance companies, others, began to sell off government securities. The Federal Reserve was committed to buy them, uh, because of that legacy of war commitment. Uh, as it bought securities, it added to bank reserves, and that gave the banks the basis for new lending. So, the banks would lend and lend, sell government securities, get the deposits, make more loans. And that was adding to an enormous expansion in the money supply

and availability to buy credit. And the Federal Reserve was afraid that such an expansion of money and credit would lead to inflation. And it wanted to restrain that.”

FRANK STASIO: The policy dispute went unresolved until the Korean War when Fed Chairman Thomas McCade refused to help finance the war, choosing instead to restrain inflation.

THOMAS McCADDE: “The Treasury is a part of the Executive Branch. The Federal Reserve is an independent agency. The Federal Reserve’s a creature of Congress, created by Congress, with independence of the, uh, political pressures from the White House. And, so, in that sense, the Treasury was not able to mandate instructions to the Federal Reserve.”

FRANK STASIO: President Truman criticized the Fed and threatened to appoint a commission to recommend changes in the Federal Reserve System, but the Fed and the Treasury Department worked out their own agreement in 1951.

THOMAS McCADDE: “Federal Reserve, uh, would be free to control money and credit without having to buy government securities. Uh, the Treasury agreed to issue some non-marketable bonds that carried a somewhat higher interest rate.”

FRANK STASIO: Monetary policy has its advantages and disadvantages as a way to stabilize the economy. One of the weaknesses of monetary policy is that it has only an indirect effect on the economy. It can regulate the size of bank reserves, but the Fed can’t obligate banks to lend their excess reserves, as we learned during the Great Depression. Another disadvantage of monetary policy is that it can hurt some industries or individuals more than others. The construction industry, for instance, with its strong need for mortgage funds, is particularly vulnerable to a tightening of the money supply. But the advantage of monetary policy is that it can be in place more quickly than fiscal remedies because it’s farther removed from the political arena. Still, some economists argue that fiscal policy has a more immediate impact on the economy once it is finally put into effect. Let’s recap some of the key points in our discussion of the Federal Reserve System. The Federal Reserve System was created in 1913 as a lender of last resort to banks in need of money to pay off depositors. It is an independent agency, created by

Congress to regulate and control the money supply by managing bank reserves. It is composed of member banks, and twelve regional banks, and is governed by the Federal Reserve Board. There are seven members of the Federal Reserve Board who are appointed by the President to serve fourteen-year terms. The Federal Reserve, also called the Fed, is the central bank of the United States. It manages the nation's money supply by changing the amount of reserves banks must hold on deposit on the reserve ratio, by changing the interest rate, which member banks borrow from the Fed called "the discount rate," and through open-market operations. Open-market operations are the most effective tool in the Fed's arsenal against economic instability. Through these operations, the Fed buys and sells government securities. When the Fed buys government securities, it increases bank reserves. When it sells securities, the bank reserves drop. The ultimate goal of the Fed is to maintain full employment without inflation. While few economists would argue that monetary policy has no impact on economic stability, there is much debate about just how effective it is in reaching its stated aims. We'll examine that question more closely in future editions of Economics USA.

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FRANK STASIO: You've been listening to Economics USA, one of a series of programs on micro and macroeconomic principle. Our guest has been Phillip Cagan, economics professor at Columbia University, and visiting scholar at the American Enterprise Institute. Economics USA has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

(MUSIC ENDS)

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