Should the Federal Reserve Be Preserved; Note

Donald J. Hubbard
SHOULD THE FEDERAL RESERVE BE PRESERVED?

There have been three great inventions since the beginning of time: fire, the wheel, and central banking.¹

The recent United States recession has sparked new cries against the Federal Reserve System. Congressional critics ranging from conservative Republicans² to liberal Democrats³ have attacked the “Fed,” and in some cases endorsed its abolition.⁴ Similarly, prominent economists and political commentators dramatize severe Federal Reserve shortcomings.⁵ Presidents Carter and Reagan have feuded with Fed Chairmen, while simultaneously shifting responsibility for the economy’s decline to the Federal Reserve.⁶ While many vehemently attack the Fed, virtually no one rises to its defense.

2. Ullman, Fed Told To Lower Rates, or Else, The Hartford Courant, Dec. 23, 1982, § 3, at 3, col. 5. The article cites Representative Jack Kemp (R-N.Y.) as a critic “who blames the Fed for the economy’s problems.” Additionally, the Fed’s congressional critics “run the gamut from Senate Democratic Leader Robert Byrd of West Virginia to conservative Republicans such as Kemp, [who] contend the Fed’s tight-credit policies for fighting inflation have exacted too great a toll on the economy.”
3. Margolis, Kennedy Launches ‘NASA’ economics to boost industry, Chicago Tribune, Feb. 6, 1983, § 3, at 10, col. 4. Senator Edward M. Kennedy (D-Mass.) in a speech before the Democratic National Committee on February 5, 1983 called for “making the Federal Reserve Board part of the Treasury Department.” In the same address, Kennedy proposed tax reform, a $7 billion dollar emergency jobs program, and “a NASA for the American economy,” involving joint government-private sector technological development.
4. Id.
5. Economist Lester C. Thurow points out:
   In most other countries, the nation’s central bank is part of the finance ministry and subject to direct control. If the bank fails in its appointed tasks, it is a failure of the Administration in power. It cannot blame someone else.
   A similar arrangement should be established in the United States. Whatever its historical merit, the time has come to end the independence of the Fed.
   Thurow, Give Reagan the Fed, Newsweek, March 1, 1982, at 29. Additionally, the astute political commentator Theodore White questions:
   A President is held responsible by the people for whether they have jobs or not, whether they eat or not. But can any President accept that responsibility if he does not have greater authority over the Federal Reserve Board? The board springs from a seventy-year-old idea for controlling the credit system.
   Like American Presidents going back to Thomas Jefferson during his fight with the first U.S. national bank, Ronald Reagan is finding it convenient to use the top U.S. banker as a sort of whipping boy for the public’s dismay over an economy that is not working very well.

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CENTRAL BANKING BEFORE THE FEDERAL RESERVE SYSTEM

An examination of American central banking evolution aids in illustrating operations of the present Federal Reserve System.

The First and Second Banks of the United States seminally influenced today's central banking system. Alexander Hamilton proposed the First Bank to Congress in 1790. Chartered the following year, the First Bank possessed broad powers to purchase and sell bullion, bills of exchange, goods pledged in lending, and holdings of public debt. The Bank utilized its position to become America's primary banking voice. To a young nation still savoring the overthrow of centralized British financial management, central banking proved intolerable. When the First Bank's charter expired in 1811, renewal failed because banking leaders and the general public viewed it as a monopoly.

Financial hardships arising chiefly during the War of 1812 created new demands for central banking. The Second Bank of the United States, established in 1816, appeared virtually indistinguishable from its earlier incarnation. It also conducted business efficiently, yet forcefully, and again incurred disfavor. The Second Bank's death knell rang during the presidency of Andrew Jackson. Appealing to the same fears and political pressures which destroyed the First Bank, Jackson ceaselessly worked against its successor until its 1836 dissolution.

State banks and the United States Treasury partially assumed the national banks' functions. The American Civil War's huge expenses caused grave financial strain, catalyzing the National Currency Act of 1863. This Act placed great responsibility upon the Comptroller of the Currency to restrict and supervise loans in order to guide business growth. The system failed chiefly because its powers were tailored to respond to Civil War financial hardships, and not to gauge long-term issues. Small banks lost flexibility because they had to place large percentages of their reserves in central banks. National bank notes did not

7. B. Beckhart, Federal Reserve System, at 4 (1972). Alexander Hamilton served as the first Treasury Secretary of the United States. The philosophical feud between Thomas Jefferson and Hamilton remains not widely known, yet its ramifications have great importance. Thomas Jefferson envisioned a future America of rural farmlands, while Hamilton correctly predicted a mass-scale urban and industrial environment.
8. Id. at 6.
9. Id. at 8.
10. Id. at 8-9.
11. Id. at 9. The Act of April 10, 1816, most notably provided that of the Bank's 25 directors, shareholders elected 20, while the President would appoint the remaining five. Under the old charter, shareholders elected all directors.
12. Id. at 13. Jackson hyperbolically proclaimed about the Second Bank that "[a]ll of its operations within would be in aid of the hostile armies and fleets without." A markedly different evaluation of the Bank came from President Woodrow Wilson, who wrote that it "had not only served its purpose as a fiscal agent of the government to the satisfaction of the Treasury, but had also steadied and facilitated every legitimate business transaction and rid the money market of its worst dangers." Id. at 13, which quotes 4 W. Wilson, A History of the American People, at 47 (1906).
13. Id. at 13-16.
14. Id. at 17.
adequately respond to demands for currency because they were tied to United States debts which steadily declined after the Civil War.\textsuperscript{15}

The banking systems succeeding the First and Second National Banks could neither adequately plan around the economy's cycles, nor address monetary shortcomings. When the public demanded gold or currency from banks, cash drains inevitably developed. When banks called in loans and liquidated other assets to meet this demand, economic contraction commenced, investment faltered, and production declined.\textsuperscript{16}

The impact of monetary laissez-faire policy climaxed in the "Rich Man's Panic" of 1907. In that year, the Knickerbocker Trust Company failed to meet withdrawal demands, thereby precipitating a severe stock exchange decline which ultimately resulted in extensive bank business closings;\textsuperscript{17} only the financial support of private financiers, most notably J.P. Morgan,\textsuperscript{18} stemmed total monetary collapse.

\section*{LEGISLATIVE HISTORY OF THE FEDERAL RESERVE SYSTEM}

The Federal Government's inability to anticipate or respond to banking crises led to a congressional consensus for a central apparatus to guide monetary matters.\textsuperscript{19} Nevertheless, six years passed from the Panic of 1907 to the creation of central banking.

Congress passed the Federal Reserve Act on December 23, 1913. The Act's preamble provided for "the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States and for other purposes."\textsuperscript{20} The Act which emerged steered between creating a powerful, singular monetary authority, and merely providing an overseeing consultative group. Specifically, the

\textsuperscript{15} Id. at 21-23.

\textsuperscript{16} See G. BACH, FEDERAL RESERVE POLICY-MAKING, at 3 (1950).

\textsuperscript{17} E. GROSECLOSE, FIFTY YEARS OF MANAGED MONEY, at 30 (1965).

The windows rang down, and the Knickerbocker Trust Company was in insolvency with $52 million of liabilities.

Panic now spread in Wall Street, throughout the nation. On the Stock Exchange call money went to 70 per cent and quotations tumbled. The ticker brought news from Pittsburgh of the triple failure of the great Westinghouse interests—the Westinghouse Electric and Manufacturing Co., the Westinghouse Machine Co., and the Securities Investment Co., along with the closing of the Pittsburgh stock exchange. As the day wore on reports came in of bank closings and business failures throughout the land. Like fire leaping a break strip, a run started on the Trust Company of America, and by closing time the bank had been drained of $13 million.

The country was now in the cold grip of crisis.

\textsuperscript{18} Id. at 34.

The panic may have been precipitated by financial manipulators, but they assumed the responsibility and leadership for arresting its spread and restoring stability. There was no hesitancy. And among them all, authorities agree that [J.P.] Morgan was chief. Abroad, his leadership was universally acknowledged, while French editorials caustically commented on [Theodore] Roosevelt's hunting trip during the crisis.

\textsuperscript{19} G. BACH, supra note 16, at 5.

The Federal Reserve Act provided for up to twelve Federal Reserve cities, each endowed with corporate powers and guided by its own directors. The System's central guidance originated from the seven member Federal Reserve Board, comprised of the Treasury Secretary, the Comptroller of the Currency, and five "Governors" appointed by the President of the United States and confirmed by the Senate. The five appointees each held ten year staggered terms, with one member nominated as Chairman by the President.

The Act empowered the Federal Reserve to regulate banks rather than to establish monetary policy. Initially the Fed provided necessary monetary coordination without amassing the flagrant power which ruined the First and Second Banks of the United States.

Ingrained distrust of centralized banking led Congress to set parameters for the Federal Reserve allowing each Reserve bank to buy and sell gold coin, bullion, specified United States bonds, notes, and commercial paper from member banks. Furthermore, Congress empowered the banks to establish rates of discount for paper subject to the Board's control, and to establish certain accounts; however, Congress did not allow the Fed to independently set rates on government securi-

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21. Federal Reserve Act, § 2. The act called for "not less than eight nor more than twelve cities to be known as Federal Reserve cities, and shall divide the continental United States, excluding Alaska, into districts, each district to contain only one of such Federal Reserve cities." Amidst much politicking, the 12 chosen cities were Minneapolis, San Francisco, Kansas City, Dallas, St. Louis, Cleveland, Chicago, Atlanta, Richmond, Philadelphia, Boston and New York. The cities remain as the present district seats. For a glimpse of the attempts by U.S. cities to procure the status of a "reserve city," see W. Harding, The Formative Period of the Federal Reserve System, at 34-38 (1925). See also E. Groseclose, supra note 17, at 90.


A Federal Reserve Board is hereby created which shall consist of seven members, including the Secretary of the Treasury and the Comptroller of the Currency, who shall be members ex officio, and five members appointed by the President of the United States, by and with the advice and consent of the Senate. In selecting the five appointive members of the Federal Reserve Board, not more than one of whom shall be selected from any one Federal reserve district, the President shall have due regard to a fair representation of the different commercial, industrial and geographical divisions of the country.

24. Federal Reserve Act, § 11. This section authorizes the Federal Reserve Board to examine accounts and demand statements from Reserve banks. The Board also received powers to suspend Reserve requirements and require Reserve banks to rediscount discounted paper of other Reserve banks. The act also permitted the hiring of all employees "deemed necessary to conduct the business of the Board."

Section 11 additionally grants the Federal Reserve Board the following powers and functions: (1) supervising and regulating the issuing and retirement of Federal Reserve notes; (2) adding to or reclassifying reserve cities; (3) suspending or removing a Federal Reserve bank officer; (4) requiring the writing off of worthless or doubtful assets in Reserve bank balance sheets; (5) suspending operations of a Reserve bank for violating Federal Reserve Act provisions; (6) making regulations for safeguarding property in the hands of Federal Reserve agents; and (7) granting national banks special power to act as an executor, trustee, administrator or registrar of stocks.

Section 11(j) grants the Federal Reserve Board authority "[t]o exercise general supervision over said Federal Reserve banks."

25. Federal Reserve Act, § 14 a-e.
ties. Additionally, Congress required each Reserve bank to maintain large reserves in gold or currency against its deposits or notes in circulation.

Although the Federal Reserve System initially relied mainly upon its discounting powers, the Federal Reserve subtly, yet markedly increased its monetary influence in 1922. To moderate the economy, the Fed began relying more heavily on its open market operations than on shifting the discount rate. Open market operations focused on withdrawing or infusing credit into the economy by buying or selling paper. Easy credit availability in theory encourages businesses to expand operations, in turn providing new jobs and a greater market for sales. Tightened credit works toward restraining inflation by controlling spending. In open market adjustments, the Fed could thus influence the economy’s expansion or contraction.

The Stock Market Crash of 1929 and the ensuing economic tailspin promoted the next great strengthening of Federal Reserve System powers. Although some commentators suggest that Federal

27. Federal Reserve Act, § 16.
29. E. Groseclose, supra note 17, at 131.
30. See, Samuelson, supra note 1, at 310.
If business is getting worse and jobs are getting scarce, the Federal Reserve Board will try to expand money and credit. But if spending threatens to become excessive, so that prices are rising and there are many job vacancies, then the Federal Reserve authorities . . . will do all that is possible to step on the brakes and contract money and credit.
31. Id
32. On October 24, 1929, a date known as “Black Thursday,” various economic forces culminated in the stock market crash. The Great Depression, the longest worldwide period of high unemployment and low business activity, resulted when stock values dropped rapidly. On black thursday, almost 13 million shares of stock were sold, and the crash started a downward movement in stock prices that continued for two years.
Prior to the crash, industrial societies enjoyed prosperous growth but ignored warnings that the economy was awry. In 1928, the residential construction industry slumped and business expenditures for capital improvements were declining. During July, August, and September, the stock market hit daily highs. On September 7, 1929, a reaction began and culminated in the crash of October 24.
The Great Depression was five times longer and harsher than any other depression experienced by the United States. From October 29, until Franklin D. Roosevelt became President in March, 1933, the economy slumped almost every month. From 1930 to 1933, prices of industrial stocks fell eighty percent. Bank failures increased as the depression continued; about 1350 banks failed during 1930 and another 2300 banks failed during 1932. These bank failures resulted in less money for industrial loans and consequently a drop in production and rise in unemployment.
From 1929 to 1933, the total value of goods and services produced annually in the United States fell from about $104 billion to about $56 billion. In 1925, about three percent of the nations’ workers were unemployed. The unemployment rate reached about nine percent in 1930 and about 25%, or about 13 million persons, in 1933. In 1932, at least 25,000 families and more than 200,000 young people wandered through the country seeking food, clothing, shelter, and jobs.
It was not until Roosevelt took office in 1932 that the Federal Government intervened with New Deal legislation and relieved the devastation of the Great Depression. The depression ended in 1942, after the country entered World War II. See generally, S. Morison, The Oxford History Of The American People 940-947 (1965); D. Wecter, The Age of the Great Depression 12-33 (1948).
Reserve policies themselves contributed to the crash, President Franklin Roosevelt and Congress vigorously reinforced the Federal Reserve System. Through the Banking Acts of 1933 and 1935, Congress built a banking structure that has since been characterized as a distinct federal governmental branch.

The most notable achievement of the Banking Act of 1933 lay in its formal creation of a Federal Open Market Committee, comprised of one member for each Federal Reserve District. The Open Market Committee became the formal apparatus for controlling growth through buying and selling securities. The Banking Act centralized

33. M. LARSON, THE FEDERAL RESERVE AND OUR MANIPULATED DOLLAR, at leaf (1975). The author rhetorically asks the reader a series of economic questions, such as, "DID YOU KNOW . . . That the Fed caused the panic of 1920-21, the stock market explosion of 1926-29, and the great collapse of 1929?" For more "questioning" of the Fed, see infra note 65.


36. SUPREME COURT OF MONEY, TIME, July 17, 1978, at 67. The Constitution divided the Government into three branches, but now there are really 3 ½—with the Federal Reserve System being the half. It has so much latitude in money and banking that it is equal in independence to the Executive, Legislative and Judicial branches.

37. Banking Act of 1933, § 8. The Federal Reserve Act, as amended, is amended by inserting between sections 12 and 13 (U.S.C., title 12, secs. 261, 262, and 342), thereof the following new sections:

Sec. 12A. (a) There is hereby created a Federal Open Market Committee (hereinafter referred to as the 'committee'), which shall consist of as many members as there are Federal reserve districts. Each Federal reserve bank by its board of directors shall annually select one member of said committee. The meetings of said committee shall be held at Washington, District of Columbia, at least four times each year, upon the call of the governor of the Federal Reserve Board or at the request of any three members of the committee, and, in the discretion of the Board, may be attended by the members of the Board.

(b) No Federal reserve bank shall engage in open-market operations under section 14 of this Act except in accordance with regulations adopted by the Federal Reserve Board. The Board shall consider, adopt, and transmit to the committee and to the several Federal reserve banks regulations relating to the open-market transactions of such banks and the relations of the Federal Reserve System with foreign central or other foreign banks.

(c) The time, character, and volume of all purchases and sales of paper described in section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

(d) If any Federal reserve bank shall decide not to participate in open-market operations recommended and approved as provided in paragraph (b) hereof, it shall file with the chairman of the committee within thirty days a notice of its decision, and transmit a copy thereof to the Federal Reserve Board.

38. See, SAMUELSON, supra note 1, at 314. To see how an open-market operation changes Reserves, let us suppose that the Fed thinks the economic winds are blowing up a little inflation. Its Open Market Committee holds the usual secret meeting. They say: "Let's sell 1 billion dollars of government bonds from our portfolio to contract Reserves and over-all credit." The motion is unanimously carried. To whom are the bonds sold? No one knows: to the open market. The dealers in government bonds—there are about half a dozen big ones—will not reveal the names of the buyers. But you can guess that they are primarily insurance companies, commercial banks, and big business firms.

The buyer will most likely pay for the bonds by a check to the Fed drawn on his bank account. The Fed will present this check for payment to his member bank. The member bank will lose an equivalent amount of its Reserve balances with the Federal...
banking by proscribing the independence of the Federal Reserve District Governors. 39

The Federal Reserve Board now possessed the means to control monetary policy more directly. The Federal Open Market Committee became the chief device to effectively influence monetary policy, and it largely co-opted the power held by Federal Reserve Districts, thus ensuring "unified monetarism." The Banking System had evolved to a stage where it possessed political insulation and powers exceeding that of the Banks of the United States.

The Banking Act of 1935 fortified the Fed's independence. The Treasury Department no longer could exert direct influence over the Fed. 40 In this manner, the Federal Reserve completely severed links to the executive branch. The Fed's relationship with the President became dictated more by cooperation and compromise than partial control from above. A system of checks and balances had emerged.

THE FEDERAL RESERVE SYSTEM TODAY

Although the Fed possesses chief authority over monetary matters, it does not wield unlimited power. The President and Senate designate new Federal Reserve Governors, and the President chooses the Chairman and Vice-Chairman. The Board must report to Congress on its policies, and must function within the framework of governmental policies. 41 Despite several constraints placed on the Federal Reserve, it maintains a strong independence and has an impressive bureaucracy to support it. The Federal Reserve Board of Governors, Federal Open Market Committee, and Reserve Banks implement policies for the System's roughly 5,500 member banks. 42

Reserve. . . . The open-market sale has cut down on the Fed's assets and liabilities. (It has also initially cut down on member bank Reserves and their demand deposits owned to the bond buyer.)

39. See G. BACH, supra note 16, at 14. Perhaps this shift of power from the separate Reserve banks to the Central Board of Governors naturally concluded from America's own centrally controlled decision making, vis-a-vis the Federal Government and the 50 states. In this light, the 1913 Federal Reserve Act resembles the Articles of Confederation, while the Banking Acts passed in the 1930's, appears more like the Constitution. See also, Does it Matter Who's Head of the Fed?, FORTUNE, Jan. 30, 1978, at 64.

40. Banking Act of 1935, § 203 b.

The first two paragraphs of section 10 of the Federal Reserve Act, as amended, are amended to read as follows:

"Sec. 10. The Board of Governors of the Federal Reserve System (hereinafter referred to as the 'Board') shall be composed of seven members, to be appointed by the President, by and with the advice and consent of the Senate, after the date of enactment of the Banking Act of 1935, for terms of fourteen years except as hereinafter provided, but each appointive member of the Federal Reserve Board in office on such date shall continue to serve as a member of the Board until February 1, 1936, and the Secretary of the Treasury and the Comptroller of the Currency shall continue to serve as members of the Board until February 1, 1936."


42. BOARD OF GOVERNORS, 69TH ANNUAL REPORT, at 233 (1982) [hereinafter cited as FEDERAL RESERVE REPORT]. The Federal Reserve's Annual Report listed 5,538 insured commercial member banks as of June 30, 1981. Of these banks, 4,506 were national banks, while the
The Board of Governors formulates policy, supervises and regulates banks, comprises the majority of the Open Market Committee, and establishes reserve and discount requirements for members. The Federal Open Market Committee determines what transactions the Fed will enter into in the free market. Each of the twelve Federal Reserve banks makes loans to member banks and earns money from interest on securities in open market operations. Additionally, each branch director establishes interest rates on short-term collateral loans.

The Fed forms monetary policy primarily by coordinating open market operations, changing member banks’ reserve requirements and regulating member banks’ discounting with Federal Reserve banks. In the open market, the Fed purchases and sells primarily government securities. By buying securities, the availability of bank reserve funds increases, thereby creating economic expansion.

Under the 1935 Act and its amendments, the Board of Governors may set reserve ratios which member banks must hold against time and demand deposits. Increasing reserve requirements restricts economic growth, while decreasing the ratio promotes expansion. In its discounting operations, the Fed exerts control over monetary growth. Through the Fed’s discount window, member banks may borrow to meet money shortages resulting from aggressive lending. By adjusting the discount rate to members, the Fed can control the amount and profitability of borrowing.

In addition to its policy-making functions, the Federal Reserve system supervises and regulates member banks. For instance, the Federal Reserve Chairman may publish rules delineating bank behavior. Additionally, the Fed prevents bank monopolies and other restraints of trade.

remainder were state banks. On June 30, 1981, there were also 8,876 non-member insured commercial banks. However, at this period, the member banks held $149,397,441m in total cash assets, as compared to $38,905,688m in total cash assets held by non-member banks. “Member banks” are those corporations choosing to keep certain reserves with the Fed, in exchange for loans and other banking privileges. See generally Peter Merrill Associates, Inc., The Federal Reserve Membership Problem: Impact on Banks (1979).

46. Id. at 49.
48. Id.
50. Id. at 79.
51. G. McKinney, Jr., The Federal Reserve Discount Window, at 6-7 (1960). “As a cost factor, it has some influence on the level of member bank borrowing (just how much influence is a matter of conjecture). More important, however, is its effect as a signal to the financial community.”
53. Id. at 115.
The Federal Reserve System influences international banking. The Board of Governors appraises current world situations in formulating United States policy, and engages in foreign exchange transactions within its authority. The Federal Reserve Bank of New York handles reserve transactions with the central banks of foreign nations. More importantly, the Fed regulates and supervises both American banks' foreign operations and non-American banks' activities within the United States. The Board of Governors gauges its member banks' activities closely; the Fed issues licenses, regulates banking, and authorizes foreign investments. Thus, although the Federal Reserve primarily deals with United States monetary policy, it possesses mechanisms which can shape international banking. By exercising its powers, the Fed helps ensure that international banking does not thwart American objectives.

CRITICISMS OF THE FEDERAL RESERVE SYSTEM

While Congress delineates Federal Reserve functions, powers, and tools, these lawmakers encounter problems in monitoring their creation. The Fed is a legislative progeny, yet not part of either the legislative or executive branch. Friction arises when the Board of Governors acts contrary to real or perceived aims of Congress or the President.

A certain envy of the Fed's insulation from political accountability accompanies the frustration elected officials feel when dealing with this independent entity. Federal Reserve Board Governors, like Supreme Court Justices, face no elections after their nominations and approvals. With little use for press coverage, the Fed can effectively remove itself from media scrutiny. Only the President and Congress must account to the public during periods of economic stagnation. Consequently, legislators use the Federal Reserve as a scapegoat to defend their own records at election time.

Elected officials often feel frustrated when Federal Reserve policies alter congressional bills or presidential goals. For instance, President Reagan became frustrated when, after his congressional budget successes, the Fed refused to lower interest rates. Thus, the Federal Re-

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55. Id. at 134. The writers explain the operating procedure as, "when the Federal Reserve intervenes in the foreign exchange markets, its trading desk at the New York Bank actually executes orders with dealers in New York."
56. FEDERAL RESERVE MANUAL, supra note 41, at 92.
57. Id. at 116.
58. M. NEWTON, THE FED, at 91-107 (1983). The author cites Robert Weintraub's study "outlining the steps taken over the years to make the Federal Reserve answerable to Congress." The author argues that Congress has largely failed in this pursuit.
60. Id., at 333-38 (1965).
61. An Interview With the President, FORTUNE, Sept. 21, 1981, at 70, col. 3. The following interview took place between President Reagan and Hedley Donovan:
Reagan: "I think what Don [Regan] was saying was that we can have and should
The Federal Reserve

serve Board is perceived as stubborn and inflexible.62

Congressional defenders of executive planning have led the charge against the Fed’s seemingly impregnable bastion controlling American monetary affairs.63 Lawmakers, perhaps understandably, argue that no non-elected body should deter implementation of elected leaders’ national programs. From this perspective, the Federal Reserve System is “undemocratic.”

PROPOSALS TO LIMIT FEDERAL RESERVE SYSTEM POWERS

A plethora of proposals to circumscribe the Federal Reserve System’s powers emerged in recent years from diverse sources. Extreme liberal64 and conservative65 spokesman have called for abolishing the Federal Reserve System. One plan advocates shifting Fed powers to

have some loosening of interest rates because they’re now contributing to
the inflation we’re trying to cure.”

Donovan: “Are you going to say that yourself?”

Reagan: “Yes, I’m willing to say it. But we can’t dictate to the Fed.”


63. Ullman, supra note 2, § 3, at 3, col. 6. “Since the summer, Fed officials have slowed the congressional drive to limit the bank’s independence by easing up its grip on credit to allow interest rates to come down.”

64. See, Margolis, supra note 3.

65. One such spokesman is Martin Larson. See M. Larson, supra note 33. The author bases his anti-Fed position on a belief that the System has been allotted too much power and has never wielded that influence wisely. In support of his thesis, Larson asks rhetorically whether the reader knows:

(1) That the Federal Reserve Act was concocted by a group of bankers and politicians at a secret meeting on Jekyll Island in 1913?

(2) That it established a government-sponsored but private banking system which controls interest and credit, issues our money, and therefore controls our economy?

(3) That in passing this Act, Congress surrendered one of its most vital constitutional mandates to a consortium of private financiers and thereby created an all-powerful fourth division in the federal government?

(4) That Woodrow Wilson was financed by the very financiers against whom he conducted a public crusade during his campaign for the presidency in 1912?

(5) That the Fed was “sold” to the American people as a permanent safeguard against depression, panics, inflation, and deflation; but that Charles A. Lindbergh, father of the Lone Eagle, correctly foretold that the Fed would create panics and depressions “scientifically”?

(6) That both world wars—which made hundreds of billions for the financiers—could not have been financed without the Fed?

(7) That the Fed caused the panic of 1920-21, the stock market explosion of 1926-29, and the great collapse of 1929?

(8) That it caused the terrible depression to continue for ten years in order to liquidate the people and condition them for war?

(9) That the Fed can cause the stock market to go up or down by rigging interest rates and by buying bonds through its Open Market Committee?

(10) That the member banks of the Fed obtain government bonds for nothing and use them to lend up to ten times their value at high interest on good collateral?

(11) That foreign bankers now own about 18,000 tons of formerly American gold which, purchased at $35.00 an ounce, will yield them a profit of perhaps $100 billion, all tax-free?

(12) That the fiat money now being issued by the Fed is unconstitutional and could become as worthless as the continentals?

Id., at leaf.
the Treasury Department. Supporters of this plan argue that by delegating these duties to an executive bureau, the President would have to answer for the Administration's economic performance. One political analyst has suggested that the Fed hamstrings the President in carrying out his elected responsibilities.

Advocates of dissolving the Fed ignore very fundamental dynamics of government. If the executive branch absorbs the Fed, a President can merely shift the blame for current economic malaise to Congress or past Administrations. Additionally, endowing a President with complete monetary control vastly expands the executive branch bureaucracy. Given what has at times been dubbed an "imperial presidency," shifting the Fed's machinery could have staggering implications for the balance of power; monetary dominance and fiscal veto could virtually supplant Congress' budgetary functions.

Many suggestions short of eliminating the Federal Reserve System have also emerged. In 1977, Paul Volcker, then President of the New York Federal Reserve Bank, cited the following legislative proposals to change the nation's monetary structure: (1) Congress should control appropriations to the Fed, (2) Congress should subject the Fed to more audits, or (3) Congress should reduce the Governors' terms. These measures strip the Federal Reserve of its present policy-making influence. Removing essential powers in this manner renders the Fed's independence a myth.

Politicizing the Fed stands as the major drawback to proposals placing reins on the System's independence. With new congressional constraints, the Board of Governors would have to exert greater pressure when lobbying their monetary programs. The Board would necessarily shift from striving to produce the best ideas to trying not to offend lawmakers. Arguably these developments could engender a more democratic atmosphere in banking; however, this argument obscures the significant powers that elected officials wield over the Federal Reserve. Additionally, as a "creature of Congress," the Fed has a solid popular foundation; banking crises and depressions have taught national leaders the necessity of placing a strong, separate, and self-sufficient entity in charge of national banking.

The historical development of the current banking system indicates that banking panics and collapses arose in the absence of central guidance. For instance, Theodore Roosevelt's otherwise capable adminis-

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66. See, Thurow, supra note 5.
67. Id.
68. ARTHUR SCHLESINGER, THE IMPERIAL PRESIDENCY (1973). The author, writing during the Nixon Administration, feared that the Presidency was becoming too powerful for democratic well being. This perceived threat eased after President Richard Nixon's resignation and the subsequent congressional rise, yet the spectre of imperial presidency may never disappear.
70. Id.
71. See FEDERAL RESERVE MANUAL, supra note 41.
The Federal Reserve could not contain the Panic of 1907. After the Panic, the compromise Federal Reserve System which emerged held limited monetary powers and operated under executive supervision. This arrangement somewhat parallels contemporary suggestions seeking to minimize, rather than entirely destroy the Fed. Both the modern proposals and the pre-Depression model seek to prevent the Fed from unwise and uncontrollably pursuing monetary policies.

The major drawback of returning the Fed to its pre-New Deal position lies in re-establishing an entity proven incapable of containing post-Stock Market Crash "fallout." If a quasi-independent Fed failed in preventing the economic depression of the 1930's, why should one suppose it will be anymore successful today? Although Congress created supplementary New Deal programs such as the FDIC and the Social Security Administration to promote economic stability, greater governmental bureaucratization and private sector sophistication place new strains on economic planning. Indeed, many commentators praise the Board of Governors for staving off monetary collapse in the wake of the present recession. Weak central control and planning provide the most inflammable fuel for igniting economic conflagration.

The current Federal Reserve System has performed as a strong steward over United States banking. The Fed has in large part prevented previously experienced banking scares by utilizing its vast array of tools. Unlike the President or Congress, the Federal Reserve Board of Governors pays detailed attention solely to the nation's monetary matters; it can predict and prevent, as well as react and respond to crises.

RECOMMENDATIONS FOR CHANGES IN THE FEDERAL RESERVE SYSTEM

Although the Federal Reserve System presently does not require major overhauls, it should not remain impervious to change. Vice

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72. See GROSECLOSE, supra note 17.
73. See Federal Reserve Act, supra notes 23, 24 and accompanying text. See also Supreme Court of Money, supra note 36: "This independence and geographical dispersion were exactly what Congress had in mind when, spearheaded by Virginia Senator Carter Glass, it created the Federal Reserve after a fight in 1913 between easy-money Westerners and hard-money Easterners. . . ."
74. See Bringing Inflation Under Control, TIME, Jan. 3, 1983, at 41, col. 1 and 2. In TIME's "Man of the Year" issue, Fed Chief Volcker was named (along with British Prime Minister Margaret Thatcher, Israeli Prime Minister Menachem Begin and E.T.) as a runnerup to "Machine of the Year," the Computer. TIME praised his job dedication, stating, "[a]lthough the Reagan Administration has been vocally committed to bringing inflation under control, waging this fight has fallen pretty much to Volcker, a 1979 appointee of Jimmy Carter's . . . . As the economic slump that began in 1981 deepened during 1982, Volcker had to perform a delicate balancing act." See also Volcker Departure Expected, Chicago Tribune, April 19, 1983, at 2, col. 2. The Tribune reports, "[o]ne thing that apparently angered White House officials was a story in the Wall Street Journal suggesting it was Volcker who saved the world economic system during the recent banking crisis, while the Reagan administration sat on its thumbs."
President George Bush currently heads a commission to study financial regulatory agencies, and to make recommendations for legislative amendments.\(^7\) While this commission may not have reached any conclusions yet, it should consider the following suggestions for altering the Federal Reserve System. These proposals offer ways for the Fed to evolve without sacrificing its efficiency and influence.

Rather than paring the Federal Reserve System, Congress and the President should explore methods to ensure greater coordination between short-term and long-term economic policy. A possible fruitful area for cooperation is controlling the escalation of outstanding loans ("the debt bomb")\(^7\) which American banks extend to third world countries. In its 1982 Annual Report to Congress, the Fed estimated that United States chartered banks had increased outstanding loans to developing nations from approximately fifty billion dollars at the end of 1978, to about $105 billion in September, 1982.\(^7\) If American banks called in their loans, several debtor countries would default, perhaps precipitating international banking collapse. Meanwhile, banks must provide new loans to ensure debtors' solvency.\(^7\)

The Federal Reserve system is probably the sole institution which could meet such an international monetary crisis.\(^9\) Ramifications of such an event would severely damage relations between the United States and the defaulting nations, causing domestic monetary shortages. Given their current responsibilities, Congress and the President also would have to address such an event.

To prepare for and monitor crises touching the Fed and all branches of government, greater policy coordination must commence. The most constructive change could arise by aligning the Fed's monetary policymaking with the goals of elected officials. Although the Federal Reserve System should remain independent, it must establish better contacts with other policy sources. In this manner, the Fed could learn more about executive and legislative aims and means, while advancing its own viewpoint.

Congress could best effect greater policy coordination by establishing ad hoc committees to defuse a crisis such as "the debt bomb." Three persons chosen by the President, the Congress, and the Federal

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\(^7\) Letter from Senator Jake Garn (R-Utah), Chairman of the Senate Committee on Banking, Housing, and Urban Affairs to author (May 31, 1983). The Commission which Vice President Bush currently chairs is named "Task Group on Regulation of Financial Services." [letter on file at the JOURNAL OF LEGISLATION office].

\(^6\) The Debt-Bomb Threat, TIME, Jan. 10, 1983, at 42-51. The cover story begins by paraphrasing Winston Churchill, "[n]ever in history have so many nations owed so much money with so little promise of repayment."

\(^7\) Federal Reserve Report, supra note 42, at 25. The report states that "about half of the total debt" was accounted for by Mexico, Argentina, and Brazil."

\(^8\) See generally The Debt Bomb Threat, supra note 76, at 42-45.

\(^9\) Id. at 44. "Since U.S. banks have the biggest overseas commitment and more than three-quarters of international loans are made in dollars, there is little doubt in financial circles that should it ever become necessary, saving the world's financial system will fall to the U.S. Federal Reserve."
Reserve Chairman would comprise each committee. The President would appoint the committee chairman, subject to approval from the Senate and the Fed's Board of Governors. Though committee recommendations need not bind any institution, the products of such a process could not easily be ignored.

Ad hoc committees would solve long-term problems involving banking, lawmaking, and shaping foreign affairs. The committees could originate before an issue becomes a crisis, and continue until they propose a stable and farsighted solution. For example, a committee might form now to defuse "the debt bomb" and develop contingency plans to stabilize banking and governmental circles. The committee would continue to operate until a majority of its members decided to end deliberations. In this manner, participants ensure that they have successfully met their objectives. If the group did not dissolve after a reasonable period, Congress could cut off funding and remove its designated representatives from the panel.

The ad hoc committee concept might extend to concerns beyond overdrawing to third world governments: unemployment, bank restructuring, and productivity issues require extensive policy consideration. Policy coordination is key.

Before the Fed, the President, and Congress embark on separate long-range policy formulation, they should gain insight into each other's plans, which stem from diverse concerns, ends, and means. Increased discussion would also produce better solutions, as the various perspectives combine to form the larger picture of policy formation. The Federal Reserve System can deflect criticism from elected officials by directly joining in planning. The Fed would maintain its independence, while not appearing unresponsive to any other decision maker.

CONCLUSION

The Federal Reserve System is not a static and unchangeable entity, but one which Congress may mold to respond to advancing technology and complexity. Congress must balance its desire to have modern issues met decisively by the Fed against its fear of unwittingly developing a new governmental branch. The ad hoc committee approach permits the Fed to voice its expertise in policy making discussions, without


Paul M. Warburg, an original Federal Reserve Governor, muses:

Fortunately, in a world of constant evolution, public opinion advances and, as time loosens the strangle hold of prejudices and party commitments, the 'political necessities' of yesterday cease to exercise their sway. Ever-changing economic and psychological conditions call for the adaptation of old laws to new circumstances; and defects in a law which had to be accepted as the price of its enactment may subsequently be corrected with comparative ease. . . . Finally, the Reserve System does not stand still. Its problems are immediate, and legislative action may be invoked at any time. When the hour for action by Congress does arrive, it is of the utmost importance that the problem be taken up in the fullest knowledge of the true facts and without partisan bias.
necessarily increasing its powers. The Fed’s independence would not diminish, yet its perceived isolation might evaporate. In seeking to renovate the Federal Reserve to address changing needs, legislators must remember that change does not necessarily usher in diminution or growth of influence.

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