ECONOMICS U$A
LESSON #9

(MUSIC PLAYS)

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Stasio: Economics U$A. One of the series of programs designed to explore Twentieth Century micro and macro economic principle. The subject of this edition is Monetary Policy and the Federal Reserve System. Our guest is Philip Kagen, Professor of Economics at Columbia University and visiting scholar at the American Enterprise Institute. I'm Frank Stasio.

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 assurances about the banking system comes as the result of the Federal Reserve System established in nineteen thirteen. Six years earlier in nineteen 0 seven, 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. Philip Kagen teaches economics at Columbia University and is a visiting scholar at the American Enterprise Institute. Doctor Kagen 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.

Kagen: 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 uh, galvanized them to uh, hold hearings. There was much discussion in Congress. Didn't happen right away. The Federal Reserve Act was passed in nineteen thirteen which is uh, 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 nineteen thirteen. And uh, the next year, nineteen fourteen, the first Federal Reserve Banks were established just in time as it is said to uh…uh, handle the financing of World War One, a purpose that it was not originally designed for.

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.

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…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.

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 fourteen-year terms. At first the Fed was given a limited mission.

Kagen: 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.

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.

Kagen: 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, depend 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.

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 of 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 nineteen twenty-nine 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.

Kagen: 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 nineteen thirties, 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

was, 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.

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

Kagen: 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.

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.

Kagen: So it's long been felt that the money supply should not contribute to the business cycle by fueling the expansion and contracting and on 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 other si uh, on the down side. Then if for any reason we, 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 up side, encouraging them to expand on the down side, would ta, would be able to counteract this business cycle pattern.

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.

Kagen: 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 uh…uh, they uh, felt that uh, 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 nineteen thirties 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 nineteen thirty-three 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 ni, early nineteen thirties. 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.

Stasio: The Banking Act of nineteen thirty-five 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 Two.

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.

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.

Kagen: 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: Okay, looking for offerings of all coupon issues for Thursday's delivery, we want the propositions back by one o'clock.

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.

Kagen: 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.

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

Kagen: 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.

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.

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.

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

Kagen: During the nineteen seventies 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 sometime 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 enforcing them to think in terms of monetary targeting.

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.

Kagen: When the Federal Reserve generally enters the market everyday 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 designed 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 everyday are conducted without any uh…uh…uh, advance announcement and then those in the market then day by day notice what the Federal Reserve is doing and respond to it.

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.

Kagen: 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 a interest on the part of the financial community to dope out exactly what the Federal Reserve is going to do and is doing.

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 Two 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.

Brimmer: As we entered World War Two the Federal Reserve undertook a commitment in January, nineteen forty-two 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.

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.

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.

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.

McCade: 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. Uh, and uh…uh, 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.

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 nineteen fifty-one.

McCade: 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.

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 nineteen thirteen 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 rated 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 U$A.

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Stasio: You've been listening to Economics U$A, one of a series of programs on micro and macro economic principle. Our guest has been Philip Kagen, Economics Professor at Columbia University and visiting scholar at the American Enterprise Institute. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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