

ECONOMICS U\$A  
PROGRAM #9:

THE FEDERAL RESERVE: DOES MONEY MATTER?

BY: MEYER ODZE AND GERALD KRELL

AIRSCRIPT  
JUNE 4, 1985

## 9. THE FED: DOES MONEY MATTER?

### PURPOSE:

To show how the responsibilities and powers of the Federal Reserve have been broadened over the years; and indicate how the Fed can control the money supply and influence the level of interest rates and inflation.

### OBJECTIVES:

1. One of the most important functions of the Federal Reserve System is to ensure that the amount of money in the U.S. economy is consistent with non-inflationary growth.
2. The Fed controls the amount of money in the economy by controlling the reserves in the banking system. This is done in three ways:
  - a) Most often the Fed injects or removes bank reserves by buying or selling government bonds—open market operations.
  - b) The Fed can also encourage or discourage bankers in their attempts to borrow reserves by lowering or raising the discount rate, which is the interest rate the Fed charges for its loans to banks.
  - c) The Fed can change the required reserve ratio or the percentage of deposits that a bank must keep in its vaults as reserves.
3. If the rate of growth of the money supply is slowed, interest rates will initially rise and both economic activity and inflation will tend to slow down. The Fed cannot control how much the reduction in the growth of the money supply will affect economic activity, and how much it will affect inflation.

### KEY ECONOMIC CONCEPTS:

Federal Reserve System  
required reserve ratio  
discount rate  
open-market operations  
money supply

### ILLUSTRATIVE EVENTS:

1. The failure of the Fed to take an active expansionary role in the early 1930s.
2. The Fed-Treasury Accord of 1951.
3. The Fed's attempt to curtail inflation in 1966 and the ensuing credit crunch.

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ANNENBERG/CPB PROJECT (Logo and Music)

TEASER

DAVID SCHOUMACHER: 1931. The Great Depression. Banks were failing by the thousands. The Federal Reserve, created to prevent such a tragedy, only made things worse. What had gone wrong? 1951. When the United States entered the Korean Conflict, President Truman also faced a battle on another front...a battle between the Federal Reserve and the Treasury...over financing the war. How would it be resolved? 1965. Lyndon Johnson's administration was spending to win a war in Vietnam and spending to create a "Great Society" at home, without raising taxes to pay the bill. The Fed was left to fight the resulting inflation alone. How well did it succeed? The nation's central bank...originally created to protect the banking system against panics...evolved into an institution with more power to affect the economy than even it had imagined at the outset. The Federal Reserve: Does Money Matter? With the help of economic analyst Richard Gill, that's the question we'll explore on this edition of Economics U\$A. I'm David Schoumacher.

(MUSIC IN-SERIES OPENING TITLES)

(The Federal Reserve: Does Money Matter appears on screen)

(MUSIC OUT)

SUPER: The Federal Reserve: Does Money Matter?

PART I

DAVID SCHOUMACHER: Coins...bills...checks...our basic money supply. The amount of money and where it goes within the banking system has been the main concern of our nation's central bank. At the Fed's headquarters, here in Washington, D.C., deliberations are held behind closed doors by experts who continuously monitor our financial health and prescribe remedies. So, how did this esteemed body of experts manage to prescribe a remedy that plunged the nation even deeper into the "Great Depression"? In the early part of the 20<sup>th</sup> century, American banks operated with little regulation and great vulnerability. In 1907 that vulnerability became apparent, when depositors lost confidence in the banks and demanded their money. Banks had no reliable place to turn for short-term loans and many collapsed. It took a powerful banker, J.P. Morgan, to end the Panic of 1907. But should an entire country be dependent on the whims of an individual? A central bank, a lender of last resort, seemed to be a better solution. Just before Christmas of 1913, President Wilson signed the Federal Reserve Act into law. It created a Federal Reserve System. Though its real operating powers were delegated to 12 regional banks across the country, its official headquarters was in Washington, D.C. Merrit Sherman, active with the Fed since 1926, describes one of its early tools to regulate banking activity...the discount rate.

MERRIT SHERMAN: "That was the first tool used when the Fed was created...the discount rate being the rate that is charged to member banks when they need to come in to get additional reserves, and it is raised to restrain their borrowing...lowered to encourage their borrowing."

DAVID SCHOUMACHER: Through World War I, through the roaring 20s, most bankers believed the banking system was safe, and they went about the business of helping the economy grow. Then one day it all came tumbling down. October 24, 1929, the greatest stock market crash in history, marked the beginning of years of economic devastation. Banks failed by the thousands. Why did the Fed fail its first major test...We asked economist Lester Chandler for an explanation...Professor Chandler, the Fed was set up after all to prevent bank failures and avoid

depressions...and there they were in the 1930s with thousands of banks failing and in a whale of a depression...What went wrong?

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

MERRIT SHERMAN: “Well, I’ll put it this way...We didn’t have very many central bankers around in this country in 1914. Central banking was not a recognized profession.”

DAVID SCHOUMACHER: Fearful that the United States was not a “safe harbor”, foreign investors began to withdraw their gold deposits from American banks. In a short time 30 million dollars in gold was shipped overseas. We asked Dr. Andrew Brimmer, former member of the Federal Reserve why the loss of gold reserves gave the Fed cause for alarm. Dr. Brimmer, in 1931, foreign investors were pulling their gold out of American banks...in other words, reserves were being depleted...Even though that gold reserve no longer plays the role it once did, what does that do to a bank and what does the bank and the Federal Reserve do to try to combat it?

DR. ANDREW BRIMMER: “For the banking system as a whole, if it experiences a significant reduction in reserves, from whatever source, it has to cut back on loans and the extension of credit unless it can get some relief. And only the Federal Reserve, acting as a central bank, can provide more relief. So in 1931, as the gold flowed out of the system, to Europe and so on, that was a loss in reserves and the central bank had to step in to make it up.”

DAVID SCHOUMACHER: The Fed was not going to stand by while American banks were drained of their reserves. It raised its discount rates...in order to force banks to push up the rate of interest paid to their depositors. The result...foreign investors earned more interest and were enticed to leave their money in U.S. banks. That ended the gold drain...but raising the discount rate had other less fortunate consequences.

DR. ANDREW BRIMMER: “If the Federal Reserve raises the discount rate, that transmits a message...It says to banks and the money market generally that the Federal Reserve wants to be restricted.”

DAVID SCHOUMACHER: For the economy as a whole the result was disastrous. High interest rates discouraged borrowing and choked off the flow of money to business. More businesses failed, more jobs were lost, and more banks collapsed. The country was pushed deeper into the “Great Depression”. Well, Professor, if you were going to give a letter grade to the Fed...A, B, C, D, F...what would it be in the 1930s?

PROFESSOR LESTER CHANDLER: “I would grade it as an “F”, applying today’s standards...probably a “D”, applying even the most advanced standards of that day.”

MERRIT SHERMAN: “Sure, you can criticize the Fed...it made mistakes...but what it did wrong was a matter of degree mostly, rather than total mistakes of policy.”

DAVID SCHOUMACHER: The men who met around this table were some of the most influential bankers in the country. They were the Board of Directors of the Federal Reserve. And when the Board met here, trying to protect its member banks by changing discount rates, they sent ripples across the entire nation. In a sense, they were practicing a rudimentary form of monetary policy. In other words, they were affecting the money supply. How important was the money supply? For an analysis, we turned to economist Richard Gill...

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

(ECONOMICS U\$A LOGO appears on screen)

RICHARD GILL: In order to understand this question, we have to have some sense of how the money supply affects the general workings of the economy and how the Fed, in turn, can affect the money supply. This diagram suggests the general nature of the answers to these questions. Theoretically, in a depression situation, the Fed should have been trying to increase the reserves available to the commercial banking system...provide “more reserves”...as stated in the first box. The hope is, then, that banks will lend out more credit to businesses, thereby increasing the general quantity of money in the economy. Thus, “more money”. “More money”, in turn, should lead to “more spending”...by businesses who have borrowed to invest in new machinery, plants and factories...possibly also by consumers like ourselves. “More spending”, in turn, should lead to higher GNP and more jobs for everyone. It may also lead to higher prices, though that didn’t seem much of a problem in the 1930s when prices were generally falling. Now when the Fed tried to stem the gold outflow by raising the discount rate in 1931, it was effectively doing exactly the opposite of what this analysis suggests. It was making it more difficult for the commercial banks to borrow from the Fed, creating a negative effect on reserves. In fact, during those years of the Depression, the country’s money supply shrank drastically. A number of economists today believe that the misdirected policies of the Fed were a major factor in turning an ordinary economic downturn into a Great Depression! We should quickly add, however, that most economists, in the years immediately following, came to a quite different conclusion. Their conclusion was that there was very little the Fed could have done anyway, that these links suggested by the arrows in our diagram would simply snap in the face of a serious depression. The Fed might make more reserves available, but the banks might be too scared to lend them out and businesses too frightened to borrow. “More reserves” might not mean “more money”! Snap! Even if more money were somehow created, people wouldn’t spend it. They would hoard it, having a strong desire for liquidity in such treacherous times. Hence “more

money” might not lead to “more spending”. Snap! But without more spending, the final link to the great objective...raising the GNP and employment...would never have a chance to come into play. In fact, for a number of years, monetary policy was generally in disrepute in this country, particularly when it came to curing a business downturn. “You can lead a horse to water, but you can’t make him drink!” “You can pull on a string but you can’t push a string”. Such was the common opinion. Our great new Federal Reserve System, like the economy it was supposed to defend, had come upon hard times indeed!

## PART II

DAVID SCHOUMACHER: The Banking Act of 1935 gave the Fed the authority it needed to use monetary policy to stabilize the economy. It also provided for an important new tool in the Fed’s arsenal...open market operations. Why then, when the Fed attempted to fully exercise its authority 15 years later, did they find themselves in open and direct conflict with the Treasury?

SPEAKER: “Our union is asking its members to invest every dollar it can in these bonds...and with God’s help and your dollars we’ll win this war for democracy.”

DAVID SCHOUMACHER: In World War II, as part of its powers to conduct open market operations, the Fed bought bonds from the Treasury to help finance the war. Fed officials felt that providing that service was essential to victory.

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

DAVID SCHOUMACHER: So the Fed bought all the bonds the Treasury wished to issue...that were not bought by the public. Dr. Brimmer explains more on open-market operations and how they affect the economy...

DR. ANDREW BRIMMER: “Open-market operations consist of purchase or sale of government securities...Purchases will supply reserves...Sales will reduce reserves. And the reserves are the basis for expanding loans and therefore expanding money and credit. Very important activity...”

DAVID SCHOUMACHER: Pumping so much money into the economy, through the purchase of government bonds, did not lead to inflation because the economy had room to expand, and because strict controls were imposed on wages and prices...It was only after the Allied victory, and the Treasury insisted on keeping the same arrangement with the Fed, that the controversy began. The Fed was as patriotic as anyone else, but they felt they were merely acting as an agent of the Treasury...and it was unclear how long the Treasury’s demands would continue. As far as the conduct of monetary policy was concerned, the Treasury was putting the Fed in a “straight-jacket”. Why were their interests in conflict?

DR. ANDREW BRIMMER: “As the economy began to expand after the war...the demand for credit rose. Banks found the 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 were very low-yielding government securities...2 %...2 % interest...when you could lend, get 5-6% lending to private borrowers. So the banks...insurance companies...others...began to sell off government securities. The Federal Reserve was committed to buy them because of that legacy of war commitment. 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 their deposits...make more loans. And that was adding to an enormous expansion in the money supply and availability of

bank 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.”

DAVID SCHOUMACHER: Then, in June of 1950, fighting broke out in Korea. It was a limited but very costly war, and it brought to a head the conflict between the Treasury and the Fed.

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

DAVID SCHOUMACHER: Chairman Thomas P. McCabe believed the Fed’s proper role was to restrain inflation, but Treasury Secretary, John Snyder, and President Truman, wanted the Fed to join ranks and help finance the war.

DR. ANDREW BRIMMER: “President Truman, in his memoirs, described the experience he had in 1917. He bought Liberty bonds. At the time he didn’t know, and most people didn’t know, that those Liberty bonds...certainly the series he bought...went up and down with market prices. And after the war, interest rates rose, bond prices fell, and many people lost a lot of money because they had to sell those bonds below what they had paid for them. Truman never forgot that experience and he thought the federal government had an obligation not to cheat people.”

DAVID SCHOUMACHER: Truman called the entire Federal Open Market Committee to the White House to give them a tongue-lashing. Never before had a president gotten so directly involved with trying to influence Fed policy. There was so much misunderstanding on both sides of the issue that Truman ordered a commission to study the matter and recommend changes at the Fed. Rather than let a

third party dictate a settlement, the Fed and the Treasury elected to meet on their own and work out a solution. The result was the Accord of 1951.

DR. ANDREW BRIMMER: “The Federal Reserve would be free to control money and credit without having to buy government securities. The Treasury agreed to issue some non-marketable bonds that carried a somewhat higher interest rate.”

DAVID SCHOUMACHER: As in any battle, there were casualties...Thomas P. McCabe resigned under pressure from Truman. He was replaced by William McChesney Martin, a key negotiator of the Accord and, ironically, an Under-Secretary of the Treasury. Following the Accord, the Fed was free to conduct monetary policies, unhampered by the constraints of the Treasury. The Fed had flexed its newly- discovered muscle, and won. Using open-market operations in the 50s...it proved to be very effective in combating inflation. The relationship with the Treasury became more equal and symbiotic. For more on open-market operations we talked with economic analyst Richard Gill...

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

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RICHARD GILL: When the Fed was engaging in open-market purchases of government securities, as it was prior to the Accord of 1951, it was effectively increasing the reserves available to the commercial banking system and thus, potentially at least, making more money available to the economy in general. The way it works is this. The Fed, purchases, say, \$1 billion of government bonds from the Treasury. It pays for these bonds by adding \$1 billion to the Treasury’s account with the Fed. The Treasury then uses this account to write checks to businesses, labor and so on, who are providing services to the government. These private individuals then deposit these checks in their own commercial banks. These deposits, in turn, become part of these banks’ reserves with the Fed. And, on the basis of these new reserves, the banks can create more money in the economy generally. Now, in fact,

this is very much like “printing-press” money, and what the Fed was saying at the time of the Accord was that this kind of easy money policy, that may have been appropriate in the Depression years, was no longer appropriate to an economy that was beginning to show definite inflationary tendencies. It was also serving notice that monetary policy, in general, might not be quite so weak and impotent a tool as once imagined!

### PART III

LYNDON B. JOHNSON: “We worked for two centuries to climb this peak of prosperity...but we’re only at the beginning of the road...to the Great Society.”

DAVID SCHOUMACHER: Great Society, notwithstanding, there was also the matter of fighting a little war...a war half a world away in a place called Vietnam. This is the Memorial to that war...and undeclared war, whose full cost was kept secret even from the President’s own economic advisors...and one that would pose a great challenge for the Fed. Could monetary policy alone harness the runaway inflation caused by guns and butter spending? A guns and butter war meant that we would try to fight abroad without making any major sacrifice of social programs at home. Spending for the war spurred the economy even higher. Factories reached full productive capacity...Labor was in demand and could command higher wages. In a classic scenario, here were sown the seeds of inflation.

LYNDON B. JOHNSON: “I believe that we can continue the Great Society while we fight in Vietnam...”

DAVID SCHOUMACHER: Meanwhile, the military chiefs were asking for more money to prosecute the war. Yet President Johnson would not propose a tax increase. We asked his economic advisor, James Duesenberry, why...

JAMES DUESENBERY: “We had, after all, just gone through a big program of tax reduction...so that turning around did not appeal to him. But I think a more significant matter was that it brought the issue of the Vietnam War into a very sharp political focus...”

DR. ANDREW BRIMMER: “William McChesney Martin, who was then Chairman of the Federal Reserve, had very good contacts...with the Pentagon and with the Defense producers. And, through the Federal Reserve System...those directors and those branches all around the country...the information was pouring in showing that the economy was heating up.”

DAVID SCHOUMACHER: To William McChesney Martin, inflation was more than a distant threat...It was a reality already on the march. The Federal Reserve Board decided to fight it...In December, 1965, they raised the discount rate.

DR. ANDREW BRIMMER: “Johnson hit the ceiling...He was angry...He announced publicly that he would call Bill Martin, the Chairman of the Federal Reserve, down to the ranch and, when he got down there, he would give a tongue-lashing.”

DAVID SCHOUMACHER: But raising the discount rate proved too small a step to keep inflation from growing...

SHOPPER: “It breaks my heart to have to go shopping...”

DAVID SCHOUMACHER: The war kept growing too and, when neither the administration nor Congress applied fiscal restraints, the Fed decided to go it alone again. This time the weapon they used was an open-market operation...In January, 1966, they sold government bonds to tighten up the nation’s money supply. The immediate effect of the Fed’s action was a dramatic rise in interest rates. Soon any business sensitive to changing interest rates was caught in a credit crunch. The

housing industry was hardest hit as mortgage money dried up. The full effect of the Fed's solitary action took hold in early 1967...inflation dropped dramatically...at a terrible cost...a zero growth rate for the gross national product. To economists this was an impressive lesson...

JAMES DUESENBERY: "The Fed was very effective indeed in 1966. The increase in the discount rate, and the reduction in the rate of creation of bank reserves, drove up market interest rates and reduced investment in residential construction by several billion dollars. That served to upset, from a broad economic point of view, the increase in Vietnam expenditures..."

DR. ANDREW BRIMMER: "I later, years later, asked President Johnson what he really thought of that episode...And he said, 'You know, Andy, Bill Martin was right, but he should have told me about it ahead of time...'"

DAVID SCHOUMACHER: The war, fought half-a-world away, affected every aspect of American life...from people to institutions. As for the Fed, it learned that monetary policy had significant power to subdue inflation...but only at great cost. We asked commentator Richard Gill...To economists at the time, how important was monetary policy?

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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RICHARD GILL: Certainly by this time...the mid-to-late 60s...everybody realized that monetary policy was important. Even in the old days, most people realized that, although you might not be able to push on a string, you could always pull on one. In an economy beset by inflation, the reverse links...reduced reserves...to less money...to less spending...to lower prices...seemed to work pretty well. Perhaps too well. For, in this final box, we might get not just lowered prices, but also lowered real GNP. And not just lowered real GNP, in general, but higher interest rates, and

the virtual collapse of certain interest-sensitive industries like housing and commercial construction. The “crunch” in the “credit crunch” of 1966 was for real. Monetary policy, it seemed, was a lot stronger tool than many had imagined. In fact, at this time, there was a general rethinking of the whole subject of money and its relationship to the economy. Perhaps money mattered a lot in depressions as well as inflations! The Keynesian consensus that had emerged from the 1930s was beginning to break up!

DAVID SCHOUMACHER: The Fed was created as a “banker’s bank”, but it has developed over the years into an institution with a much broader mandate. The role of monetary policy has evolved by fits and starts and response to the demands of history. The Great Depression showed that the Fed did not fully understand the implications of its own power. The Korean War underscored the need for the Fed’s independence...and the Vietnam era’s inflation graphically illustrated both the power and the problems of monetary policy. Now there’s a good deal more to be learned about monetary policy, and so it’s a subject that we’ll be returning to again...in future editions of Economics U\$A. I’m David Schoumacher.

ECONOMICS U\$A (LOGO AND MUSIC)

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