In more than 70 countries, workers have real bargaining rights...

The Federal Reserve We Need

It's the Fed we once had -- when a more democratically accountable bank was enlisted to patriotically finance America's war debt.

TIMOTHY A. CANOVA | *October 11, 2010*

Throughout the past year, Federal Reserve Chair Ben Bernanke has led the choir in warning about the size of the federal deficit. In July, he endorsed extending George W. Bush's tax cuts for the wealthiest households, while suggesting the need for spending cuts to offset the revenue loss. Bernanke's repeated alarms have heightened fears that public deficits could "crowd out" private borrowing, force up long-term interest rates, and choke off the anemic recovery.

Bernanke's view may well be the consensus of both Washington and Wall Street. But it is also the polar opposite of the fiscal advice offered by one of Bernanke's most effective predecessors, Marriner Eccles, the Fed chair in the 1930s and 1940s. Eccles called for larger deficits and increases in government-spending programs to pull the country out of the Great Depression. He then went on to enlist the Fed to finance the huge World War II debt at low interest rates, so that the postwar recovery could flourish. Eccles was proved emphatically right, first in 1937 when the economy fell into a steep nosedive after the Roosevelt administration tightened fiscal policy and then again when the massive World War II fiscal stimulus of the 1940s ended the Great Depression once and for all and fueled the highest economic growth rates in American history.

Today's fiscal conservatives prefer to ignore the history of the 1940s, a period when the Federal Reserve was far more accountable to elected officials and far more independent of the private financial interests that have come to dominate the Fed in recent decades. During the 1940s, the federal government spent and borrowed far greater than today as a percentage of overall economic activity. Today, federal spending is about 25 percent of gross domestic product; in the 1940s, spending peaked at nearly 45 percent of GDP. Today's federal deficit is about 9 percent of GDP; in the 1940s, the deficit peaked at 31 percent of GDP. Today, the federal debt held by the public is about 61 percent of GDP; in the 1940s, it peaked at over 114 percent of GDP. Did those higher spending and debt levels bankrupt the U.S. economy? Quite the contrary -- federal spending was critical to the war effort and the success of the U.S. economy.

After the war, massive federal spending funded social policy on a grand scale through the GI Bill of Rights, which made available job training, tuition-free higher education, health care, and housing subsidies to nearly 16 million returning veterans, a third of the workforce. The GI Bill thereby bolstered an expanding middle class and created the conditions for sustainable economic growth. The growing economy pushed up tax revenues, lowering the debt burden and helping the federal government pay down debt.

Although federal spending and borrowing in the 1940s was much higher than it is today, there was no rise in interest rates. From 1942 to 1951, the Federal Reserve was accountable to democratically elected officials. It was directed by the White House and Treasury to peg interest rates at three-eighths of 1 percent on short-term Treasury borrowing and 2.5 percent on long-term borrowing. This so-called pegged period of public finance began in the weeks following the Japanese attack on Pearl Harbor. As the Federal Reserve itself would later describe the division of responsibilities, the amount of government spending was properly determined by Congress, and it was the Treasury's responsibility to determine the rate of interest it would pay on its borrowing. It then became the Fed's duty to purchase government securities in any amount and at any price needed to maintain the interest-rate pegs for Treasury.

***

During the past two years, the Federal Reserve has purchased more than a trillion dollars of mortgage-backed securities, the so-called toxic assets held by the Fed's banking and hedge-fund clientele. The actual purchases have been shrouded in secrecy. In contrast, during the 1940s the objective of the Fed's open-market operations was more transparent and socially neutral. It was not to bail out private financial interests but rather to accommodate the federal government's fiscal-policy agenda.

With the 1940s Federal Reserve accommodating the administration's hyperactive fiscal policy, the U.S. economy grew at a real annual rate of 15 percent to 20 percent and more than doubled in output during the war. Private investment was crowded in, not out, as much

of the spending went for contracts with the private sector, and a buoyant economy allowed consumers to purchase goods produced by America's corporations. Industry boomed and businesses returned to profitability. The U.S. emerged from the war with enormous productive capacity, as the world's largest creditor, and with huge trade surpluses, conditions which allowed it to play a commanding role on the world stage. By the end of the war, with the jobless rate at 1.2 percent, full employment was a reality for perhaps the first and only time in American history, and the distribution of income became much more equitable as a result of the strong economy, low yields on Treasury securities, and progressive taxation.

Since the Federal Reserve could no longer ratchet up interest rates to preempt potential inflation during this pegged period, the federal government had to find new ways to keep prices stable. During the war, the administration turned to temporary price controls as well as bond sales to the public and highly progressive taxes to dampen consumer purchasing power. Even after price controls ended in 1947, inflation was only a temporary problem, and by 1949 prices were falling across the board. This may well have reflected the country's expanded supply. Federal spending did not simply pump up demand; massive federal investments in infrastructure and factories expanded the nation's industrial capacity, thereby reducing inflationary pressures.

Meanwhile, the Federal Reserve imposed strict lending standards on its member banks, including interest-rate ceilings and selective credit controls to raise margin requirements on private borrowing for purchases of corporate securities, housing, automobiles, and consumer durables. Though many of today's critics blame the crisis on low interest rates, the real problem was low rates coupled with deregulation: When low rates are combined with a well-governed financial sector, they help the economy grow. Likewise, there has recently been much concern expressed that today's federal deficits could result in a global contagion against U.S. securities that would undermine the value of the dollar as foreigners sell off their holdings of Treasury securities. During the pegged period, this was largely prevented by a range of central-bank restrictions on short-term capital flows, including restrictions on the sale of Treasury debt abroad. Although today's proposals for taxing speculative capital flows seem quite tame by comparison, they have nonetheless been rejected for more than a decade by both the Federal Reserve and Treasury.

***

Throughout the 1940s, the Federal Reserve's willingness and ability to impose a range of selective credit and capital controls reflected its relative independence from private financial interests and its accountability to democratically elected institutions -- a kind of central-bank role that has been all but ignored in recent decades.

The combined efforts of the Federal Reserve and the Office of Price Administration kept annual inflation below 3 percent for the final three years of the war. But political support for the interest-rate peg was eventually undermined after the war because of the Truman administration's failure to contain inflation. President Harry S. Truman and Congress fought over the OPA's authority, which was weakened, vetoed, lapsed, renewed, and then finally abolished in 1947. Then with the outbreak of the Korean War in June 1950, Truman seriously underestimated the scale and length of the war, its impact on inflation, and the restiveness of the Federal Reserve and its private financial constituency.

In fact, Congress and public opinion were well ahead of Truman on the need for direct controls on prices and wages in wartime. Likewise, Eccles and other members of the Federal Reserve were calling for renewed authority to impose selective controls. Without controls, they argued, the peg would need to be relaxed so the Fed could raise interest rates to stem inflation in consumer prices and asset markets. But Truman resisted until January 1951. By then, the country had experienced six months of sharply rising prices, with retail prices increasing at an annual rate of nearly 12 percent and wholesale prices, at an annual rate of 24 percent. From December 1950 to February 1951, the three peak months before the controls were adopted and took effect, the consumer price index rose at a 19 percent annual rate.

This inflation coincided with a dramatic and effective revolt of the money managers. The banking industry had been pressuring for a return to markets setting interest rates, and the Federal Reserve itself, no longer chaired by Eccles, was painting pegged rates as a relic from World War II. With the help of key conservative allies in Congress, the Fed prevailed, culminating in the Treasury-Federal Reserve Accord of March 1951, which ended the system of pegged interest rates.

Although it was the combination of direct and selective controls that quickly broke the inflationary momentum, the Fed soon began using its newfound freedom to raise interest rates at the first signs of any inflation, thereby bringing on three recessions during the Eisenhower era and raising the interest burdens on federal, state, and local governments, a harbinger of our present troubles. It also returned to its pre-1933 role of looking out for the interests of the big banks, rather than the public interest, as its primary constituency.

During the 1930s, Eccles had pushed for structural reform of the Federal Reserve to remove the "banker interest" from its crucial Federal Open Market Committee, which sets monetary policy. Eccles came up short in that effort, just as Congress did most recently in the Dodd-Frank Wall Street Reform Act when it dropped proposals that would have reduced private control of the FOMC by making the 12 regional Federal Reserve Banks more accountable to elected officials.

Unfortunately, it is the banker interest that has skewed Federal Reserve policy, first in its lax regulatory oversight leading to the financial crisis and since then, in its response to the crisis. The experience of the 1940s suggests that the Fed could accommodate much larger federal deficits to energize a sustainable economic recovery. That, in turn, would transform the current debate about what scale of temporary enlarged debt the economy needs and can sustain. Instead, the Fed has been pushing reserves into the banking system in exchange for toxic assets while hoping the banks will lend to consumers and businesses in an environment of severe economic insecurity. Eccles himself had criticized this approach as "pushing on a string" and largely ineffective. Eccles recognized that central-bank accommodation of large public deficits would prove far more effective than pushing reserves into the banking system as long as the federal government spent wisely in putting people back to work and investing in the long-term infrastructure needs of the nation.

Since the fall of 2008, the Federal Reserve has been pushing on a big string. Its balance sheet has expanded by some $2 trillion, much of which is some $1.25 trillion in purchases of toxic mortgage-backed securities from private financial institutions, including banks with ownership interests in the regional Federal Reserve Banks. In addition, the Federal Reserve has lent more than $1.5 trillion to those same private financial institutions in exchange for more toxic assets as collateral. Instead of investment in the real economy, this strategy has been one of spending on toxic paper assets.

Meanwhile, the scale of all these hidden subsidies to banks, which began when Treasury Secretary Timothy Geithner was heading the New York Fed, far exceeds the cost of the Obama administration's fiscal stimulus. While the Fed's private constituency of large Wall Street banks and hedge funds has enjoyed low-interest loans and outright sweetheart purchases of their toxic assets, governments at all levels must slash budgets, cut public services and payrolls, and thereby undermine the fragile economic recovery.

How different is the current reality from the 1942-1951 Federal Reserve, which provides a model of what a democratically accountable central bank would look like when working with elected branches to achieve the three primary objectives of Keynesian economics: maintaining genuine full employment; reducing the tremendous inequalities in wealth and income that undermine any sustainable recovery; and putting an end to the monopolistic structures and financial practices that harm taxpayers and consumers alike. The Fed in the 1940s supported much higher levels of deficit spending, which were needed for a recovery at low interest rates. In contrast, today we have low interest rates, but they are supporting business as usual in the banking sector, which is not translating into recovery for the real economy, while the Federal Reserve is part of the alarmist chorus about deficits.

Few economists ever learn this period in Federal Reserve history, which has been airbrushed from most mainstream texts, including Bernanke's own economics textbook. To the extent that the Eccles period is discussed at all, it is dismissed as an anomaly -- which, sadly, it was. Today's new normal is a central bank captured by private financial interests that is pursuing an elite agenda of deregulation, fiscal austerity, and bailouts and bonuses for bankers. But as our nation's own history shows at one of America's finest hours, it doesn't have to be that way.

★★★

Timothy A. Canova is Betty Hutton Williams Professor of International Economic Law at the Chapman University School of Law in Orange, California.