



Is the Federal Reserve Independent?

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The debate concerning the independence of the Federal Reserve has been a constant since the passage of the act establishing it. Indeed, among the powers delegated to Congress in Section 8 of Article I of the Constitution of the United States is “To coin money, regulate the Value thereof, ...”. Thus, to the extent that the Federal Reserve can do the equivalent of coining money, and by the rate at which it does this, regulate the value thereof, it would appear that the Constitution precludes us from having a truly independent central bank.

That said however, Congress can delegate powers to agencies and thus can establish a central bank and give it the power to coin money and regulate the value thereof. This delegation of the right to coin money and regulate the value thereof meant little for the period of our history when we were on a metallic standard. Essentially, the value of domestically coined money was determined by the world price of gold with the exception of those periods

where the free exchange of money for gold was curtailed.

One such period was the Greenback era during and following the Civil War. During this period, both gold coins and Greenbacks circulated with continuously changing exchange rates. Congress authorized the printing of Greenbacks and by the extent of the issue regulated the value thereof. In contrast, the value of the gold coinage was outside the ability of the Congress to regulate.

In one sense it could be argued that the issue of an independent central bank could only be relevant in a world without a metallic standard. Thus, even though the Federal Reserve System began operation as a central bank in 1914, as long as the United States remained on the gold standard it was limited in its power to coin money and regulate its value.

However, for the question of an independent central bank the past is irrelevant. Once the nation eliminated the rights of citizens to exchange currency for gold in the

1930s we left the gold standard. Now we had a central bank that had the ability to coin money and regulate the value thereof.

Importantly, having the ability to coin money did not mean that the Federal Reserve was independent of the central government. The period from the 1930s until the March 1951 Treasury-Federal Reserve accord is generally considered a period of Treasury, and thus, either Congressional or Executive control of Federal Reserve policy. This is reflected in Allan Meltzer’s classic work, *A History of the Federal Reserve*, in which Chapter 7 of the first volume is titled, “Under Treasury Control, 1942-1951.”

But as I’ll suggest below, Treasury control of Federal Reserve policy while seemingly strict, was not a factor in at least one critical area, that of financing central government deficits. The Treasury or Executive control of the Federal Reserve for the period of World War II was in two areas. One, requiring the Federal Reserve to operate in fi-

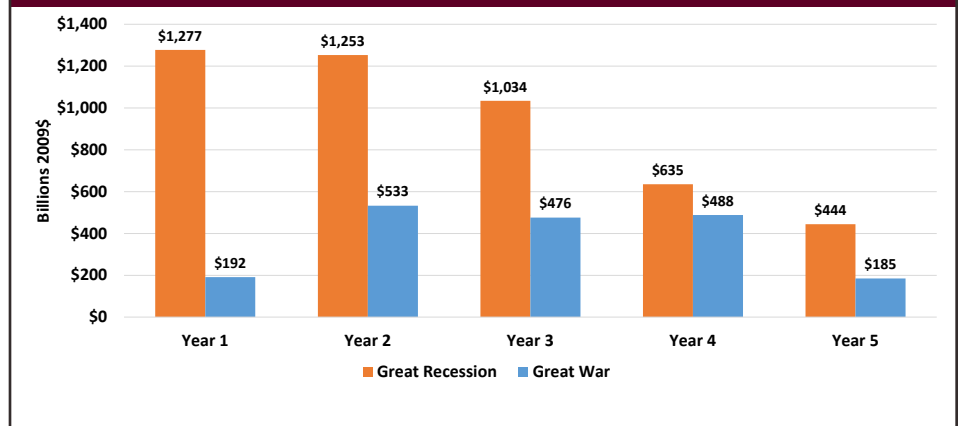
financial markets so that the interest rate on T-bills remained at or below 0.375 percent and 2.5 percent for long-term government bonds. Two, controlling consumer borrowing for durables to help offset the fact that the manufacturing of these durables was reduced during this period.

To get a perspective on what Treasury dependence would mean, consider the Treasury problem of War finance. Traditionally, when countries with central banks went to war they suspended the ability of citizens to exchange bank notes for gold and proceeded to increase the note issue to support the war debt. This activity was tantamount to the Treasury running the central bank. Considering the general patriotic feeling during the War effort and the mandate that the Federal Reserve control the cost of servicing the mounting War debt, it is surprising how little monetizing of the debt occurred. For the entirety of the five War fiscal years, the Federal Reserve monetized less than 9 percent of the federal deficits.

First we'll compare federal spending during the Great War and the Great Recession. For this comparison Figure 1 shows the federal deficits for the five fiscal years immediately after the official trough of the Great Recession and the five fiscal years of the Great War. Notably, the Great Recession spanned fiscal years 2010 through 2014 and the Great War spanned fiscal years 1942 through 1946. To make the deficits comparable they are expressed in 2009 dollars.

It does not take much imagination to see that the Great Recession deficits make the Great War deficits

Figure 1. Great Recession Deficits vs Great War Deficits, Billions 2009\$



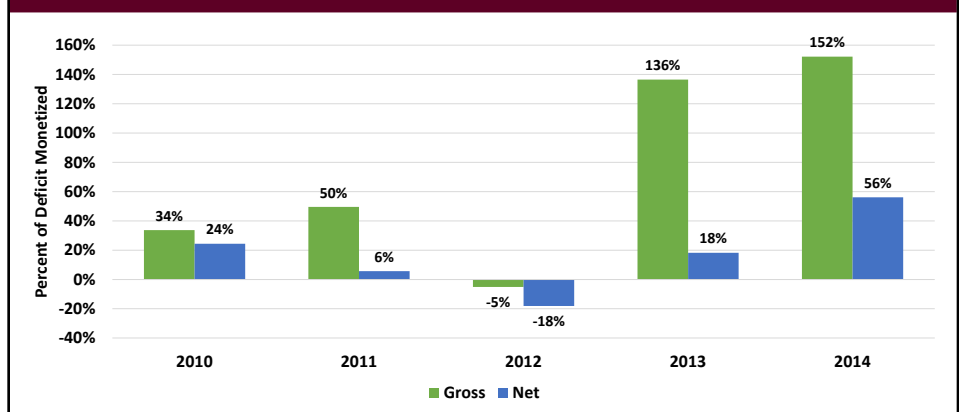
look very small. The sum of the five Great Recession deficits total \$4.6 trillion 2009 dollars while the sum of the five Great War deficits totals \$1.9 trillion 2009 dollars. Just think about these numbers for a minute. The Great Recession deficits beginning fiscal 2010 would have paid for almost 2.5 World War II's!

Now let's turn to the Great Recession and the modern, independent Federal Reserve. Figure 2 shows both the gross and net Federal Reserve monetization of the Great Recession deficits from 2010-

2014. The green bars in the figure show the percentages of the annual deficits financed by the expansion of the Federal Reserves' asset portfolio. Over these five years the expansion of the asset portfolio exceeded 55 percent of the cumulative deficits. In contrast, the Treasury-dependent Great War Federal Reserve financed less than 9 percent of the wartime deficits.

Given this simple approach, one question remains: Why didn't the expansion of the Federal Reserve assets result in significant inflation?

Figure 2. Gross and Net Percentage of Federal Deficits Monetized in the Great Recession, 2010-2014





The answer lies in a fundamental change in Federal Reserve policy that began in October 2009, the beginning of fiscal year 2009. That change was the payment of interest on Federal Reserve member bank reserves at a rate of interest that exceeded the return on all Treasuries up to those with 2-year maturities. In effect, the Federal Reserve bought long-term securities from the Treasury and Mortgage backed securities from Fannie and Freddie and issued Federal Reserve short-term liabilities.

As a result, the net increase in federal debt financing done by the Federal Reserve, the blue bars in the above figure, was reduced by the amount of Federal Reserve created short-term federal debt; this was done by paying interest on the reserves, making them the equivalent of federal short-term debt. In effect, the payment of interest on member bank reserves induced the banks and not the public to hold the equivalent of federal debt.

Figure 3 shows the level of Federal Reserve security holdings at

the close of each fiscal year and the level of Federal Reserve liabilities in the form of bank reserves. Given that the Federal Reserve must pay the banks to hold reserves the level of these reserves is appropriately treated as a Federal Reserve liability. Thus, in each of the fiscal years the Federal Reserve financed the deficit by buying securities and then incurred a liability by paying interest on the reserves generated.

That these reserves are the equivalent of federal debt follows from the little understood fact about the Federal Reserve. That is, the Treasury “owns” the Federal Reserve because it is the recipient of all Federal Reserve profits, that last year were almost \$100 billion. As a result, any income yielding asset the Federal Reserve purchases is the equivalent of buying a Treasury security and any interest yielding Federal Reserve debt is equivalent to selling a Treasury security.

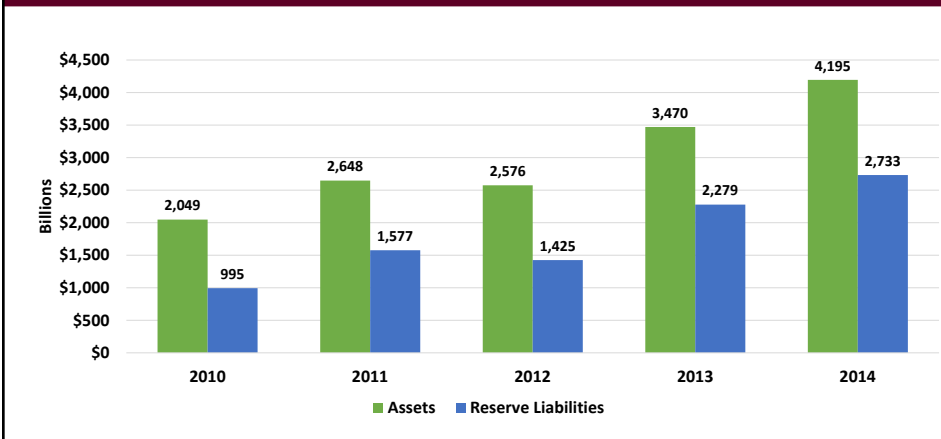
Figure 3 also shows the net position of the Federal Reserve. The difference between assets and liabilities rose from about \$1 to \$1.5 trillion

between 2010 and 2014. For any fiscal year, the net contribution of the Federal Reserve to the financing of the federal deficit is the difference between the additions to Federal Reserve assets less the increase in its interest yielding liabilities.

Thus, while at first glance it would appear that the Federal Reserve was a partner to the Treasury financing more than half of the Recession debt, the facts are that its contribution was much smaller. In fact, the lack of inflation that would be expected with the Federal Reserve’s expansion of its assets is the result of the Federal Reserve paying member banks to hold most of the money coming off the printing press. On net, then, given that we have observed little or no inflation even with unprecedented federal deficits is what we might call a sterilization of much of the money printed to finance these deficits.

The real question that remains is when, if ever, will the Federal Reserve stop paying the banks to hold reserves rather than increase loans to the economy? To the extent that an independent central bank’s charge is to preserve the purchasing power of the dollar the current \$2.4 trillion of reserves cannot just be let loose. It is encouraging that in spite of the pressure to finance the federal deficits and work with the housing industry, the Federal Reserve has found a way to prevent the expansion of its assets from causing rampant inflation.

Figure 3. Federal Reserve Security Holdings and Reserve Liabilities, 2010-2014





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Spring 2016

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