GROUPEMENT D'ETUDES ET DE RECHERCHES
NOTRE EUROPE

Président : Jacques Delors

THE AMERICAN FEDERAL RESERVE SYSTEM :
FUNCTIONING AND ACCOUNTABILITY

Axel KRAUSE

Research and Policy Paper N° 7
April 1999

44, Rue Notre-Dame des Victoires
F-75002 Paris
Tel : 01 53 00 94 40
e-mail : notreeurope@notre-europe.asso.fr
http://www.notre-europe.asso.fr

This study is also available in French and German.

Axel Krause

Axel Krause has been a Paris-based correspondent and editor for American publications for over twenty years, including "Business Week" magazine and the "International Herald Tribune". Currently, he is a regular contributor to "Europe" magazine, published in Washington, United Press International and TV5, the French International channel. A graduate of Colgate and Princeton universities, he is secretary general of the Anglo-American Press Association of Paris, and board member of the association of French economic and financial journalists (AJEF). He is the author of "Inside the New Europe", (Harper Collins, 1991) that appeared in translated and revised editions in Japan and France ("La Renaissance - Voyage à l'intérieur de l'Europe") in 1992.

Notre Europe

Notre Europe is an independent research and policy unit focusing on Europe – its history and civilisations, process of integration and future prospects. The association was founded by Jacques Delors in autumn 1996. It has a small international team of five in-house researchers (British, French, German, Italian and Portuguese) coordinated by Christine Verger, the association's secretary-general.
"Notre Europe" participates in public debate in two ways. First, publishing internal research papers and second, collaborating with outside researchers and academics to produce contributions to the debate on European questions.
The association also organises meetings and conferences in association with other institutions and publications.
In accordance with the statutes of the Association, the "European Steering Committee" meets at least three times a year. The members of the Committee are of various nationalities and diverse political and professional origin.

INTRODUCTION

The approach to this report was journalistic, starting with the basic outline, which is built around ten very frequently asked questions :

1. What is the legal-constitutional basis for the Federal Reserve System's power ?
2. How is the Fed structured today ?
3. Why did it take 122 years to get there ?
4. To whom is the Fed accountable ?
5. Why have the Fed's strongest critics been unable to significantly change the way it operates ?
6. What accounts for the memorable impact of William McChesney Martin, Jr. ?
7. What motivated and helped Paul Volcker to successfully combat double-digit inflation, while presiding over a recession ?
8. Why and how has Alan Greenspan remained so popular ?
9. Where do the media fit into the Fed's approach to accountability ?
10. Can the Fed provide any lessons for other democracies ?

The quest for answers required reading recommended books and articles and a selected bibliography is included at the end of the report. Interviews played the crucial role, however, since accountability is rarely, if ever, addressed comprehensively, as a separate topic by academics, journalists, bankers and others assessing the historical role of the Fed. A list of those interviewed is also contained at the end of the report. Virtually all were conducted on an off-the-record-basis, which enabled them to speak freely, in Paris, London, Brussels, New York and Washington.

Of those interviewed, I would like to express my appreciation, in particular, to an old friend, whose help and generous counsel helped enormously: Peter Bakstansky, senior vice president of the Federal Reserve Bank of New York.

Axel KRAUSE

QUESTION 1. WHAT IS THE LEGAL-CONSTITUTIONAL BASIS FOR THE FEDERAL RESERVE SYSTEM'S POWER?

> "The Congress shall have power to lay and collect taxes, duties, imports and excises, to pay the debts...to borrow money on the credit of the United States...to coin money and regulate the value thereof."
>
> Section 8 Article 1, Constitution of the United States (1787)

The Beginning

In the late eighteenth century, having successfully inspired and led a revolutionary war against the English monarchy, and with many of them representing propertied families, the American founding fathers establishing a new democracy were suspicious of centralized executive power. Thus, when it came to assuming the nation's debts and managing fiscal and monetary policy, the decisive, political power was vested neither in the executive branch of the government, nor in a central bank. Rather, these powers were placed under the authority and scrutiny of the Congress, comprising the Senate and the House of Representatives.

Quickly, however, President George Washington (1789-1797) and members of his administration found themselves struggling with the problems of promoting economic growth, trade with Europe and implementing the remarkably brief provisions of the Constitution, that had been ratified in 1789. It was in this context that an intense debate gripped leaders in the thirteen former colonies. The question then was whether or not a central bank was necessary and, above all, was its creation constitutional?

Fervently opposed to the plan was Thomas Jefferson, one of the towering founding fathers, a distinguished jurist who had recently left Paris as ambassador, and whose political party, representing mainly rural interests, would evolve into the modern Democratic Party.[1] He argued that since the Constitution did not specifically empower the Congress to create a central bank, it had no right to do so. Backed by farmers and other populist groups, Jefferson continued to oppose the bank even after he was elected America's third president (1801-1809) amid continuing debate in that predominantly rural America, which would continue for many decades to come.

Jefferson's arch-rival, Alexander Hamilton, also a lawyer, who was Washington's Secretary of the Treasury, and represented mainly urban merchants and entrepreneurs, argued with equal force that the Constitution stipulated the ends, not the means, for implementing monetary policy. Therefore, he said, Congress could - and should - establish a national bank, possibly resembling the Bank of England, in order to manage the nation's money supply and regulate the availability of credit, which business interests were actively seeking. Washington

---

[1] An extremely good account of the various clashes between Jefferson and Hamilton is contained in "Thomas Jefferson - A Life" by William Randall; Harper Collins Perennial, New York, New York; 1994, pp. 493-514.

agreed with Hamilton and signed the law already passed by the House and Senate. Thus, he cleared the way for chartering the First Bank of the United States in 1791 for a period of twenty years.

Although it had few functions of a modern central bank, with a majority of its capital in private hands, the bank's creation represented the first delegation by Congress of its financial powers to an outside entity, not specified in the Constitution. To the present day, the Fed's existence is marked by a typically American fact of constitutional life that contrasts with the British and European experiences : Congress created the bank, voted on and oversees the laws affecting its various roles. Yet, the House and Senate have always retained the legal right to rescind the founding legislation.

That point was dramatically restated nearly two centuries later, as the 1980 recession began to spread throughout the economy. Then, as later, the Fed was being criticized and attacked by many Americans for stubbornly maintaining high interest rates. Fed Chairman Paul Volcker, to whom we shall return later, was bluntly told by angry senators that if he failed to ease the Fed's restrictive monetary stance, the Congress would move to enact legislation that would, in effect, order him to follow their orders. At one particularly animated hearing, the then minority floor leader, Democratic Senator Robert Byrd, exasperated, asked Volcker to whom, after all, did he think he was accountable? "Well", Volcker replied, "The Congress created us, and the Congress can uncreate us. "[2] Responding to a similarly-motivated line of questioning, Volcker told another critic that "Congress has the authority over the Federal Reserve. It's a question of the degree to which they're going to exercise it."

The process Volcker refers to perplexes many observers. Members of the European Parliament, central banks and of the European Central Bank, the ECB, are among those who recently held talks in Washington, seeking to understand why and how U.S.-style accountability functions as it does, particularly with regard to Congress. Most return home more or less enlightened, realizing that the Fed's role evolved only gradually, with many historical gaps, where there simply was no federal role. That perplexing role has been subject to permanent, regular scrutiny- known as oversight in Washington parlance - which often occurs amid political and ideological controversy that continued up until several years ago. The controversies have by no means disappeared. Yet, there is now a wide consensus in America that the Fed System, on balance, works efficiently, and has served the economy well, considering it has played a major role in fostering nearly nine years of steady growth.

To help clarify the buildup in its complex, legal foundation, it might be useful to consider the following milestone, legislative steps.

[2] This account and others that deal in detail with the Volcker years are contained in the well-written, controversial "Secrets of the Temple" by William Greider, Simon & Schuster, New York, 1987. Note the chapter "Slaughter of the Innocents".

The Founding Laws

The Federal Reserve Act of 1913

Following the refusal by Congress to renew the charters of the first and second national banks in, respectively, 1811 and 1836, banking in the United States for decades, was conducted by state-chartered banks, with virtually no federal regulation. Only on the eve of The First World War, reacting to monetary turmoil, bank failures and panics among shareholders and customers that traumatically marked banking history of the early twentieth century, did Congress establish the nation's third, but first, modern central bank. The bill passed by both the Senate and House was signed by President Woodrow Wilson at the White House on December 29, 1913. The law created a powerful Washington base in the form of a Federal Reserve Board, but with many banking responsibilities delegated to twelve regional, or district, banks to which we shall return.[3]

The basic purposes specified in the law were not, however, to regulate interest rates, but to provide the nation's economy with an elastic currency; to establish facilities for discounting commercial credits, and to improve the supervision of the banking system, while positioning the Board to pursue "other purposes". Paradoxically, monetary policy, as it is currently practiced in democratic systems around the world, was not cited as a purpose, and evolved only gradually in subsequent years.

And although President Wilson and his financial advisors made headlines around the world by establishing America's first independent central bank, that independence was relative, and accountability in its currently used context, was a term not heard frequently in the nation's capital and for good reason: to make sure the bank would remain responsive to government goals in pursuing monetary policy, the Wilson administration insisted that the law provided seats on the Fed's seven-person Board of Governors for the Secretary of the Treasury and the Comptroller of the Currency, a government agency responsible for supervising national banks.

The Banking Act of 1935

What had been termed "Wilson's Great Compromise", because it attempted to blend governmental and banking interests, was greatly strained in the early years of the Great Depression. With many businesses bankrupt, and some forty percent of the nation's banks gone, the relatively decentralized system for regulating the money supply was challenged by Democratic President Franklin Roosevelt. His zealous, reform-bent financial advisors soon began drafting new laws that would centralize control over the then loosely-structured Fed system in Washington.

More specifically, to offset entrenched power of the banking interests operating the twelve reserve banks, each defending their regional interests, the Board of Governors was given administrative authority over their operations. At the same time, the new law provided the

[3] An excellent description of this period is contained in "Historical Beginnings...the Federal Reserve" by Roger T. Johnson, Federal Reserve Bank of Boston, Boston, Mass. 1995.

Board with substantial, formal insulation from political control: both the Secretary of the Treasury and the Currency Comptroller were removed as members. This ended formal, direct administration involvement in shaping monetary policy. Consequently, White House-Fed relations became more distant, fuzzy, subject to many new political pressures, while providing the Fed even more leeway in pursuing its goals and implementing its policies.

In a related move, Congress also voted to end the then-established open market operations controlled by the regional banks, which included the vitally sensitive setting of discount rates. Responding to the Roosevelt administration's demands, the legislature approved creating the Federal Open Market Committee, the FOMC. As this influential rate-setting body was being established, some members of Congress argued that only the seven, Washington-based governors appointed by the President should set monetary goals and policy; others urged that a large measure of control over monetary matters should be left with the regional banks.

The law, as finally approved, representing compromise, gave all seven governors and the President of the New York Reserve Bank permanent seats on the FOMC to which we shall return. But only four of the remaining eleven regional banks were given a vote on a rotating basis. This balancing act reflected Congress' will to maintain checks and balances on the Fed's newly centralized authority, while further reinforcing its independence, which has continued to the present. A clearer mandate for economic objectives was, however, not written into the legislation.

Full Employment and Balanced Growth Act (commonly called the Humphrey-Hawkins Act, for its main sponsors) of 1978

This milestone law, building on 1946 legislation calling for full employment, was passed amid escalating inflation and unemployment that gave rise to the epithet "stagflation". The predominant view in many government circles was that inflation destroyed jobs, or could certainly not create them and, therefore it was felt, Congress should approve new legislation that would formally establish reinforced guidelines for monetary policy. The law broadly stated what Congress now wanted the Fed to do - navigate policy between sustainable levels of inflation and full employment, a mandate which has continued to the present. This contrasts with the single-focus of some foreign central banks, notably Germany's Bundesbank and the ECB, which are legally bound to respect price stability, meaning to fight inflation if needed, as their first priority. The frequently cited American law of 1978 law states:

> *"The Board of Governors of the Federal Reserve and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-term potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."*

Attaining the objectives, however, was not all Congress had in mind for the Fed.[4] The need for greater transparency also was incorporated into the law. Thus, the act established what has become well-publicized routine in Washington: each February, the law states, the Fed must publicly announce its objectives to the Congress, outlining its objectives for growth of money and credit. Then, in July, the Fed must formally review the objectives for legislators and revise them if appropriate. Previously, the Fed chairman and other Fed officials testified before the House and Senate committees, but formal reports were not required, and what information was submitted proved scanty and inadequate, angering some lawmakers. The new law, amending the Federal Reserve Act, also provided for regular audits of the Fed by the General Accounting Office, the GAO, an investigative branch of Congress that acts as a budgetary watchdog of governmental agencies.

[4] A balanced account of the Fed's power base is contained in an article, "Is The Fed's Power Legitimate?" by John M. Berry of the Washington Post, in Central Banker, spring issue, 1996.

QUESTION 2. HOW IS THE FED STRUCTURED TODAY?

> "No one designing a central bank from scratch would ever have come up with the Federal Reserve System of the United States. It is a product of compromise - a pretty queer duck as one critic described it."
>
> John M. Berry of the Washington Post

Who Does What

The critic cited by Berry happened to be a powerful Democratic congressman, which is ironical, considering that the Fed's structure was, as we have seen, designed by Congress with a view to ensuring its independence and formal accountability with regard to its members. Let us first look more closely at the structure in its present form:

-- The Board of Governors is, for lack of a better term, a central governmental agency. Similar to justices of the U.S. Supreme Court, another branch of the government, its members are placed deliberately outside the formal, direct reach of the executive branch, or supposedly so.[5] This means that the Fed's decisions cannot be reversed by political fiat or whim by anyone except the Congress.

The Board comprising seven members, are appointed by the President, and must be confirmed by the Senate. Traditionally, this occurs following hearings and thorough questioning by senators who can, on occasion, prove skeptical, unfriendly, or even hostile depending on the candidates. Board candidates put forth by the White House, even for the post of vice chairman, have on very rare occasions been withdrawn when hostility proved determined.

The full, non-renewable term of a board member - called governor - is fourteen years. But appointments are staggered so that one term expires on January 31 of each even-numbered year. The chairman and vice chairman are also appointed by the President, but to renewable, four-year terms, and also require Senate confirmation.

Headquartered in an imposing, white-marble building on Constitution Avenue in the Foggy Bottom district of Washington, supported by a staff of 1700 men and women, the Board's responsibilities extend well beyond monetary policy.

In keeping with its 1978 mandate, and working closely with the twelve regional banks, (located in New York, Boston, Philadelphia, Richmond, Atlanta, Cleveland, St. Louis, Chicago, Minneapolis, Kansas City, Dallas and San Francisco) the Fed supervises and regulates the U.S. banking system. The Board's authority to determine member commercial banks' safety, soundness and compliance with the law also extends to all U.S.-based bank holding companies; the foreign activities of member banks, representing about one third of

---

[5] One of the best, current descriptions of the Fed's structure and functions is contained in "The Federal Reserve System - Purpose And Functions", Board of Governors, Washington, D.C. 20551, 1994.

the nation's 8000 commercial banks; the activities on American territory of foreign banks and other institutions conducting foreign banking activities.

Reserve banks by law have been chartered as private institutions, because regional commercial banks own the stock. Yet, they, too, are subject to oversight by Congress, and their presidents must be approved by the Fed Board; their officers also testify before congressional committees.

The Fed's financing is generated, not by congressional appropriations, the established method for virtually all government agencies, but from its own revenue-generating operations.[6] We shall return to this unusual, yet crucial, mechanism when exploring the question of why the Fed's critics in Congress have been unable to significantly influence the way the Fed operates.

Governors are expected to maintain regular, formal and informal contacts with other branches of the government, Congress, members of the banking and financial community, with each member assigned responsibility for a specific sector of the Fed's activities. Thus, for example, the chairman has formal responsibility for the Fed's international relations. He is the alternate U.S. member of the Board of Governors of the International Monetary Fund, is a member of the board of the Bank for International Settlements and attends as a U.S. delegate meetings of finance ministers and central bank governors of the Group of Seven industrialized nations, the G-7.

The Board is responsible for publishing detailed statistics and other information about the economy and the Fed's activities, most of which are available to the public. The Board exercises broad responsibility in operating the nation's bank payments system and administers most of the nation's laws that apply to consumer credit protection. The Board has supervisory and regulatory control over the twelve regional banks. Each has its own board of nine directors chosen from outside the bank; three represent Fed-member commercial banks; the remaining six may represent business, labor, consumer and other, non-banking affiliated interests. Each Reserve Bank has its own staff of full-time officers and employees and some, like the St. Louis Reserve Bank, have drawn international acclaim for the quality of its monetary studies.

-- The New York Fed, by virtue of its size and influence, is in a league of its own among reserve banks and has been from the beginning.[7] In the run-up to 1913, leading private financiers, notably the highly-influential J.P. Morgan, wanted the New York Fed to represent about half the system's total capitalization to reflect New York City's might as the nation's financial capital. Although this proposed share was subsequently reduced to accommodate others, the New York Fed remains the system's largest district bank, performing central banking functions. It is located in an imposing, 14-story Renaissance-style headquarters building in the heart of Wall Street, employing some 4000 men and women.

[6] A description of the process and of the current budget is contained in "Annual Report: Budget Review", Board of Governors of the Federal Reserve System, Washington, 20551, April 1998.
[7] A concise description of the New York Fed is contained in "A Day At The Fed", The Federal Reserve Bank of New York, New York; 1998.

Reflecting this role, the New York Fed President, currently William J. McDonough, is a permanent, voting member of the Federal Open Market Committee, the FOMC, and its permanent vice chairman. In response to decisions of the FOMC, charged by law to set and implement national monetary policy, the New York Fed is responsible for conducting domestic open market operations, which involve the purchase and sale of U.S. government - mainly Treasury - securities, to influence the level of reserve availability set by the FOMC. The New York Fed is also responsible for foreign exchange operations in order to avoid speculative upheavals and to strive for orderly conditions in the exchange markets, but particularly for the dollar. These foreign exchange operations are conducted in New York headquarters on instructions of the Treasury in Washington and often are coordinated with key, central banks around the world.

Reflecting yet another dimension of formal accountability, the Board relies on an array of advisory and working committees, all established by law, three reporting to the board directly. They include:

- The Federal Advisory Council. This body is composed of commercial bankers, one named from each of the regions. The council meets with the Fed Board four times each year in Washington to discuss the nation's economy and banking issues.
- The Consumer Advisory Council. This body consists of thirty members, drawn from the academic community, the legal profession and from groups representing the consumer and financial industries. The council meets three times a year to discuss, and make recommendations on, issues related to consumer credit protection that are administered by the Board.
- The Thrifts Institutions Advisory Council. This body was established following congressional approval of the 1980 Monetary Control Act, which extended the Fed's reserve requirements and services to a major component of the nation's banking system: savings and loan associations, savings banks and credit unions. Most are represented at the council's Washington meetings.

-- The FOMC is, however, the embodiment of decisive leverage over the American economy in a critical area. As the government's monetary locomotive, the FOMC is entrusted with secrecy-shrouded authority over open market operations. These transactions are conducted in the U.S. securities market, mainly in Treasury bills with maturities of one year or less. Overall trading in the treasury market averages some $100 billion daily. The FOMC influences the market by lowering or increasing the federal funds rate. This is the rate charged by a depository institution on an overnight sale of bank reserves to another financial institution that, likewise, obtains its funds from other commercial banks.

Reserve requirements of banks and of other financial institutions, as well as the key discount rate - the interest rate charged commercial banks when they borrow reserves from a regional Fed bank - are not, however, set by the FOMC. They are set by the Fed Board, usually with close coordination between the two. How does this baffling system work?

First, consider who Alan Greenspan, the current Fed chairman, faces when he opens a meeting of the FOMC in the Fed's ornate boardroom in Washington. Seated around an oval, ten-meter long mahogany table are the twelve voting members. They include the seven board governors headed by Greenspan; the New York Fed's McDonough, and four other regional Fed presidents. However, unlike their New York-based colleague, they serve only one-year terms on a rotating basis. Only these five regional presidents can vote on policy decisions. The others, however, participate in all FOMC discussions and frequently help shape the outcome. Staff members of the Board also attend, usually representing those responsible for research, monetary and legal affairs, congressional relations and communications.

Second, it is important to note that formal FOMC meetings are held in the nation's capital only eight times a year. Telephone conversations are, however, occasionally organized at the discretion of the chairman. Communications, particularly media relations, to which we shall return, are tightly structured and disciplined. Considering that broad analyses are made in speeches by Fed officials beforehand, market speculation on a Fed move usually precedes a major shift in monetary policy. But there are few if any leaks about what is actually going to happen. This is part of a deliberate, structured, Board-run communications strategy to create maximum impact in the markets and in public opinion. Most observers agree the strategy works most of the time.

It is the Board and its chairman who usually announce major decisions to the world. Thus, on October 15, 1998, the Fed stunned the financial community, triggering an immediate stock-market rally, by announcing the second in a series of reductions in the federal funds and the discount rates. And, significantly, it was the first time in four and a half years that the FOMC changed interest rate policy outside one of its regular meetings. The explanation is not to be found in the Fed's structures, however, but in the personality and style of its brilliant, influential chairman to whom we shall return.

QUESTION 3 : WHY DID IT TAKE 122 YEARS TO GET THERE?

> "The passage of the Federal Reserve Act stands as almost a textbook case of wise and skillful presidential leadership over Congress."
>
> Robert T. Johnson, "Historical Beginnings...The Federal Reserve"

From the time the First Bank of the United States was chartered by Congress in 1791 until the chartering in 1913 of the third - and presumably final version of a U.S. central bank - the history of the Fed was shaped by a fundamental dichotomy in American political life: between the strong, deep commitment, on the one hand, to populist, rural and fundamentalist democratic values, and, on the other, to the more pragmatic, Yankee, business-inspired system of values of city dwellers, rooted in what Johnson terms "urban reality". We have already briefly examined the earliest bitter clash over this dichotomy between Jefferson, who lost the first battle, and Hamilton, who won.

To better understand how this debate influenced the broader issue of accountability in the past two centuries let us examine, briefly, one of the most colorful, populist leaders of the last century, whose influence extended up to the outbreak of World War One, and whose ideas linger on in congressional circles today - Andrew Jackson.

A southern, Populist Democrat, military hero and lawyer, who was easily elected the country's seventh President in 1829, Jackson had declared war on the Second Bank of the United States shortly after moving into the White House labeling it "the monster". Although chartered by Congress in 1816, partly to combat an inflationary spiral triggered by the naval war with Britain of four years earlier, and although headquartered in Philadelphia, like its predecessor, the bank, for Jackson, was founded on "distrust" and an "absence of faith" in the popular will of the American people. What this meant for him and his "Jacksonian Democratic" supporters was simple: the bank must, first of all, serve their interests, particularly those of farmers, workers and the rapidly-emerging middle class, but certainly not those of large, prosperous banks and corporations,. Jackson repeatedly claimed they were controlled by "easterners and foreigners", which for most Americans of that era was hardly a compliment.

Many observers at the time recognized more than a hint of demagogy in Jackson's approach. Yet, he was touching a sensitive nerve in the subconscious of many Americans, summed up by Greider as follows: "Something in the American character resented the idea of a central bank." And yet, surprisingly, even today's astute, widely-admired chairman, Mr. Greenspan, concedes that the Fed has a long way to go in improving its image. "The perception that we are a secretive organization, operating behind closed doors, is not always in the interests of the nation as a whole", Greenspan said recently, a theme to which we shall return.[8]

---

[8] Speech by Alan Greenspan, "The Challenge of Central Banking in a Democratic Society", Washington, D.C., December 5, 1996.

As early as seven years before its charter was due to expire, Jackson was on his anti-Second Bank war-horse, claiming it was refusing to respond to, and thus was holding back, the fast-moving westward expansion of the private banking system; he blamed the central bank's restriction of state banking credit, which it could do, given its relatively-independent status. Despite repeated calls from the White House for support on Capitol Hill, the Congress generally supported the Second Bank throughout the early 1830's, forcing the President to make a spectacular move that to this day has affected the traffic pattern on a very symbolic street in downtown Washington - Pennsylvania Avenue.

A new office building to house the Treasury was being planned at that time, but certainly not to be located on Pennsylvania Avenue, a broad, grandiose avenue that had been conceived by French architect Pierre L'Enfant as a way of architecturally linking the White House and the Capitol Hill district of Washington, where the Congress is located, providing both an unobstructed view in each direction. The story has it that Jackson became so angry at the Senate, which generally favored re-chartering, that one day he stepped out of the White House, gestured with his cane to the middle of Pennsylvania Avenue, and ordered: "Build it here!" Why? Although historians still dispute the actual words, Jackson, who never was shy about using profanity, reportedly explained that he wanted the new Treasury Building to "block my view of that damn place", meaning, of course, Congress.[9]

In 1832, more determined than ever, Old Hickory, as he was known, vetoed the approved Congressional bill to renew the bank's charter on the grounds that it was unconstitutional; Jackson warned of "such a concentration of power in the hands of a few men, irresponsible to the people". The Presidential election of that year, widely viewed as a national referendum on the issue, went heavily in his favor, with the result that when the charter finally expired in 1836, significant political support for a central bank evaporated.

For the next 25 years, the American banking system operated under the aegis of a loose, complex of state-chartered banks, with virtually no federal regulation. Financial operating conditions were chaotic, marked by frequently-violent fluctuations in the amount of notes issued by banks and in the amount of checking deposits held by banks. The system also suffered because of insufficient reserves, inadequate capital, and the deliberate willingness by many banks in the system to take on questionable loans. Consider the following account of what was happening in the 1860s in the state of Louisiana, which had been purchased by the United States from France's cash-strapped leader Napoleon in 1803.

Of the more than 900 different paper bills in circulation during that period there was, for example, a $10 note issued by the Citizens Bank of New Orleans. Printed on one side of the bill was "ten" and on the other side, "dix", the French word for ten. Gradually, as the notes became favorites of gamblers working the Mississippi River boats, their popularity spread throughout the South, taking on the name "dixies". And thus, legend has it, the entire South became known as Dixie.[10]

[9] European Currency Union speech at a seminar at the House of Commons, London, by Lawrence Lindsey, May 9, 1996, p. 15.
[10] "Inside the New Europe" by Axel Krause, HarperCollins, New York; 1991, p. 194. "La Renaissance: Voyage à L'Interieur de l'Europe", (French revised translation) Le Seuil, Paris, 1992, p. 21.

National, but not centralized nor federal banking, continued throughout the 1860s. Yet, in keeping with the spirit of the times, the institutional relationships between banks related to check-clearing, for example, remained under private control. This helped account for the inelastic state of the nation's currency and immobile reserves, which were held in fifty different cities. An unstable, cyclical pattern of booms and busts characterized this period, as increasingly, bankers and government planners in the late 1890s turned their attention to the idea of a central bank. By 1907, following a severe financial panic that dramatically jolted the nation to the shortcomings of private control over national banking, Americans at last began to move on significant reform.

In keeping with its constitutional role, Congress in 1908 once again took the initiative by passing legislation to make the money supply somewhat more elastic, while establishing a National Monetary Commission with a view to proposing a major overhaul in the nation's money and banking-control system. This would take another three years of exhaustive investigations and hearings.

What emerged in 1910 was a plan drafted by Republican Senator Nelson Aldrich, a pillar of the eastern establishment that had been so bitterly attacked by Jackson. Once again, Aldrich's plan that appealed to the banking community, and had little public support, was quickly seized upon by William Jennings Bryan, a Nebraska Populist and a brilliant orator, who repeatedly described Aldrich's proposal to the Commission as a "currency scheme of big financiers."

On a more positive note, leftist progressives, led by Bryan, began to mobilize political support for federal, governmental control over the nation's banking system. The 1912 election of Democrat Woodrow Wilson, former governor of the state of New Jersey and president of Princeton University, as the nation's 27th president, would prove decisive. During the presidential campaign, he used such slogans as: " the greatest monopoly in this country is the money monopoly". Once installed in the White House, his approach became more sanguine.

Wilson began listening to several of his close financial advisors, notably Congressman Carter Glass of Virginia, who would become chairman of the influential House Committee on Banking and Finance; Glass proposed establishing some twenty, privately-controlled regional reserve banks, which would hold a portion of members' reserves, perform central banking functions and issue currency against gold and other assets. Wilson, however, insisted that this was not enough and proposed establishing a central board, a governmental agency, that would oversee the system. Understandably, the banking community, still powerful, did not like Wilson's approach, and attacked it as imposing far too much governmental control over the nation's banking system. Democratic Party supporters, led by farm interests, mainly in the West and South, argued the opposite, amid growing splits in the Wilson Administration.

Seeking compromise, Wilson insisted that what he was already calling a Federal Reserve Board, be placed under direct, government control, yet committed to an elastic currency. Far from satisfied, conservative Republicans, backed by banking interests, continued the attacks that year, accusing Wilson of promoting a "communistic idea". Then Wilson accepted, and put forth, the idea of a Federal Advisory Council, consisting of banks, to serve as an intermediary between the reserve banks and the Federal Reserve Board. By agreeing to additional compromises, yet refusing to budge on the idea of a modern Fed, and by skillful lobbying on the Hill, the Federal Reserve bill was passed by narrow margins. On December 23, 1913, several hours after the Senate had approved the bill, Wilson, surrounded by his supporters and family, signed the Federal Reserve Act. Speaking with what he described as "deep emotion", the president said he believed the Fed "will be of lasting benefit to the business of the country."

QUESTION 4 : TO WHOM IS THE FED ACCOUNTABLE?

> "Any central bank or monetary policy institution which stresses only its independence and ignores its ultimate accountability to the body politic may soon find its independence at risk. It will have lost touch with its ultimate mission - serving the public at large."
>
> Lawrence Lindsey, former Fed governor

Defining the Concepts

Addressing a seminar at the House of Commons in London in May 1996 while still at the Fed, Mr. Lindsey was explaining what he described as tension between accountability and independence which, he declared, "cannot be escaped". He told his European audience that the challenge they faced in establishing rules for the ECB was to "successfully balance" the two concepts, noting that some would view accountability and independence as "polar opposites". In his view, however, it is precisely this tension, this institutional balance, that matters most insofar as central banks are concerned. But, he cautioned, "this may be particularly difficult as the political structure of the (European) Community is itself evolving".[11]

While avoiding transatlantic comparisons, the author of this report faced an obstacle in seeking a suitable translation of the word accountability in French, normally a precise language. A somewhat exaggerated explanation comes from one of America's most highly-regarded Fed watchers, David Jones, vice chairman and chief economist of Aubry G. Lantson & Co., a leading Wall Street firm specialized in government securities. Noting that the ECB took less than a decade to become established ; that its primary goal is price stability and that it has "maximum authority, and minimal accountability and reporting requirements," Jones concludes that the European Central Bank is "by far the least politically accountable central bank in the world."[12] If Jones is correct, it means there is no handy translation into French for accountability today because the practice itself remains illusory, while evolving.

When politically-minded American economists and central bankers speak of accountability, they generally have in mind a concept which is closely tied to - but separate from - the notion of independence. Most do not consider them to be identical forms of responsibility, even though they may be related. Indeed, in contrast to some thinking in Europe, independence alone is no guarantee of a central bank's legitimacy or credibility. Clear and insightful analysis on this question comes from Alan Blinder, a former economic advisor to President Bill Clinton and who in 1994 became vice chairman of the Fed, and has returned to his post as professor of economics at Princeton University. In his lectures, writings and in a recent interview, Blinder poses the question : isn't there something fundamentally undemocratic about making a central bank independent of political control? The same question, applied to

[11] Ibid. pp. 21-22.

[12] "Outlook for the Euro and the Dollar", Dr. David M. Jones, Christiana Bank Annual Outlook Conference ; Bergen, Norway, August 27-29, 1998.

the ECB, has been raised by a handful of leaders in the European Union, mainly leftists, scattered among member government and in the European Parliament.

Answering his question, Blinder makes a crucial point: Congress established the Fed with the support and approval of successive occupants of the White House and provided it ways of remaining independent, but with the constitutional obligation to remain bound to its parliamentary will. And there is no time limit on the binding, because as he and others note, the Fed’s modus operandi can only be changed by the Congress itself. From the late eighteenth century onward, the two houses have been entrusted with translating the popular will into legislation, supposedly for the common good of the nation, hence the quasi-permanent rationale for accountability. "As I often said, while I was on the Fed," Blinder recalls, and noting that monetary policy has impact on the lives of ordinary citizens, "it’s their economy, not ours."[13]

Without drawing conclusions at this point, let us examine the three most important institutions to which the Fed is accountable, to which it must respond formally and informally: the Congress, the White House and the markets ; a fourth, relatively new area of accountability - the media and public opinion - will be examined separately in Question 9.

The Congress

Veteran Congressman Barney Frank would have appealed to President Andrew Jackson. A longtime Democrat who got into politics shortly after graduating from Harvard University in 1962 by becoming the chief assistant to Mayor Kevin White of Boston, he made his way up the Washington political ladder slowly. An outspoken liberal and a lawyer, Frank was elected to the House of Representatives in 1972, representing voters in the Boston area, many unemployed in sectors such as fishing and textiles. Like Jackson and his followers, Frank doesn’t like the way the Fed operates. And as a key member of the House Banking Committee, his voice counts.

On April 8, 1997 on the floor of the House, Frank delivered one of his typically strong attacks on the Fed and on Greenspan, and, specifically, regarding his well-prepared, ritual testimony to the House banking committee in which the chairman defended recent FOMC decisions to raise interest rates.[14] "We asked him...whether there was any evidence of inflation given the growth that we have seen in recent years. His answer was candidly no. He admitted that he had been too pessimistic; he has been wrong over these past years," Frank told the House, arguing the economy need more expansionary policies. But Frank, echoing the views of other, mainly Democratic congressmen and senators, also attacked the Fed as representing "a handful of appointed officials and private bank officials". What to do ?

---

[13] "Central Banking in Theory and Practice" by Alan S. Blinder, The MIT Press, Cambridge, Mass., 1998, page 68.

[14] News Release from Barney Frank, Washington Office, 2210 Rayburn House Office Building, Washington, D.C. April 10, 1997.

Frank pledged to work with his colleagues in an effort to make the FOMC "better reflect the important public nature of the decisions it makes," disclosing that he was considering introducing legislation that would, for example, remove the five regional bank representatives on the FOMC and replace them with the Secretary of the Treasury and the Chair of the President's Council of Economic Advisors, another key, economic cabinet post. "Mr. Greenspan has told us we were creating too many jobs in America. Many of us of course feel that our problem has been that we have not created enough jobs," Frank emphasized. That was in the spring of 1997.

Only a year earlier, shortly after the Clinton White House began seeking Senate confirmation of Greenspan for a third, four-year term as Fed chairman, Democrat Senator Tom Harkin of Iowa was on a similar warpath. His goal was to block necessary Senate approval of Greenspan in order to achieve what he, Frank, and other Democrat lawmakers wanted from the FOMC : lower interest rates, and a reversal of the Fed's tight monetary policy. A deadlock followed, and for several weeks not even direct, personal appeals to Harkin from fellow Democrat Bill Clinton changed his mind. "The Fed is fundamentally misreading the American economy. They ought to get out from behind their desks and see what is really happening in plants and on factory floors," Harkin declared in a speech on the floor of the Senate, claiming he had support for his blocking move from colleagues. "Another reason to dump Greenspan," Harkin added, "is that he has been highly political, despite the supposed non-partisan nature of the independent central bank."[15]

Such pressures to, in effect, fire a Fed chairman, or force changes in the way the Fed operates are not new. They reflect what an excellent study describes as a long, American tradition of "populist and progressive suspicions over the concentration of economic power," whose background we described briefly earlier in the report. By far the most active, anti-Fed agitation in recent history occurred between 1979 and 1990. A total of 200 bills were introduced in Congress during this period that addressed a total of 56 issues.[16] Nearly half of the proposed laws were aimed a reversing the very-tight, anti-inflationary monetary policy being pursued by Fed Chairman Paul Volcker ; 36 bills sought to increase the political accountability of the Fed through procedural changes, including for greater transparency of FOMC decisions and restoring the Secretary of the Treasury's seat on the board; several bills called for the impeachment of Volcker himself, while shortening the 14-year terms of the governors by between two to twelve years. Other bills would have ended the Fed's critical immunity from Congress's traditional hold over federal government agencies through budgetary appropriations to which we shall return.

We also shall be examining in Question 5) the reasons behind the failure of these and other moves, and in Question 6) the Volcker era. Suffice it to say here that legislators who share Frank's views have by no means given up. "The Fed is enormously powerful, in this country, but we feel vindicated," said the congressman said in an interview and who easily won re-

[15] Mr. Harkin speaking on replacing the Federal Reserve chairman, Congressional Record - Senate, February 7, 1996.

[16] A very exhaustive study of the Volcker era, from a congressional perspective. "The Political and Institutional Independence of U.S. Monetary Policy", by M.A. Akhtar and Howard Howe, Federal Reserve Bank of New York, May 1991.

election in the November congressional elections.[17] He cited the Fed's recent moves to reduce interest rates, asserting that in his view, Greenspan had turned "moderate", while surrounded by monetary hawks. He also cited the leadership of the House Banking Committee under former chairman Henry Gonzalez of Texas, which in 1994 touched off an embarrassing incident for the Fed by publishing the account of how, for fifteen, previous years, the Fed had secretly taped FOMC meetings without the knowledge of most members. The House released some of the transcripts with the formal recommendation that "one way to ensure that government officials are working in the public interest is to enforce the requirement that a detailed record of their decisions and actions be kept and made public...(and therefore proposes) the FOMC to prepare a verbatim transcript of its meeting for release to the public within 60 days of the meeting."

Until 1976, transcripts in edited form were made public, a practice ended by the then-Fed Chairman Arthur Burns at a time when Congress was considering laws that would force prompt public disclosure of virtually all government policymaking meetings. The so-called "policy directive" - as the minutes were known in those days - were issued by the Fed until 1995, a system characterized by the House Banking Committee as "vague, useless and a poor substitute." Reformers, like Frank, take credit for having forced the introduction of today's relatively open system, pledging to work for similar actions in the future. Under current practice, FOMC decisions are published immediately following a meeting. A complete, edited report, including on how members voted, is published with a lag of between six to eight weeks, and a longer transcript after a lapse of five years.

Partly as a result, but on a totally different question, the current chairman, Republican Congressman James Leach, also from Iowa, in October strongly criticized the Fed for its handling of the attempted rescue of one of America's largest and most heavily leveraged hedge fund, Long Term Capital Management, LTCM. Committee sources said that other committee members from both parties said that the Fed had no business leading such an operation, and that public hearings were being considered that would focus on the Fed's role as a banking regulator, to which we shall return in a moment.

The White House

It is sometimes said that the best way to understand the Fed's relationship to the White House and other branches of the executive branch is to think of the bank in a somewhat paradoxical way - being independent within the government, but not independent *of* the government. In practice, this role has proven relatively easy, difficult, strained, or virtually impossible to sustain, depending on the personalities involved and, of course, the historical economic contexts. And yet, there is nothing in the Fed legislation that suggests the bank must keep the White House informed of what it may be planning. However, consider the following :

In 1951 during the Korean War, the Fed was determined to not only fight inflation , but allow the markets to determine the value of U.S Treasury securities and not the administration, as had been the practice going back to the beginning of World War Two. President Harry Truman, vehemently opposed, one day invited the entire FOMC to the White House to "twist

[17] Interview with the author, Washington, October 13, 1999.

their collective arm".[18] An uproar resulted. Both sides openly disagreed about what was said at the meeting, notably Truman's allegation that he had an agreement with the FOMC that he would approve its future financial market operations - in advance. In the end, a compromise was worked out, which allowed the Fed to conduct open market operations as it saw fit. There was a casualty : the then-Fed Chairman Thomas McCabe, after being told by the White House he was no longer "effective", resigned.

Other striking examples of strained, sometimes-tumultuous relations between the administration and the Fed can be found in later periods, notably during the 1960s under President Lyndon Johnson, and a decade later under President George Bush. In addressing the following questions we shall try to understand Fed-House relations in those eras, and the comparatively tranquil period under President Clinton, which is remarkable for the way it began.

Thirteen days before the president's inauguration, Clinton and his top economic advisors met in Little Rock, Arkansas. It was January 7, 1993.[19] The main organizer was Robert Rubin, currently Treasury Secretary ; Leon Panetta, who would become White House chief of staff and Alan Blinder, among others. The purpose was to forge goals and the means for implementing them. Panetta grimly predicted that with only modest, lackluster 2.5-3% growth and continued heavy government spending, the budget deficit would rise to a record $360 billion by 1997 and to around $500 billion by the turn of the century. Blinder made a detailed case for substantial budget reductions, but argued that only with lower, long-term interest rates would there be a way of making the needed deficit reduction "costless." The catch was that, in order for the strategy to work, both the Fed and the bond markets had to respond favorably, for as Blinder argued to his colleagues, lower interest rates would stimulate the economy and take up the slack caused by a projected $60 billion cut in the federal budget deficit.

Probably the best account of what happened next is contained in Bob Woodward's book, The Agenda, which has been confirmed with reliable sources, close to Clinton. At the president-elect's end of the table, Woodward wrote, Clinton immediately turned angry and stunned with disbelief. "You mean to tell me," the president is quoted as saying, "that the success of the program and my reelection (in 1996) hinges on the Federal Reserve and a bunch of fucking bond traders ?" Everyone in the room agreed that the answer to the question was - well, yes.

Thus, the stage was set for a distinctly harmonious Fed-White House relationship that has continued into 1999, amid some skirmishes and disagreements, conditioned by a relatively-healthy, growing domestic economy and a decidedly turbulent international environment, particularly in Asia. Yet as Clinton himself grasped at the historic Little Rock gathering, there is far more to influencing the American economy and succeeding in monetary policy than getting along with the Fed and its chairman.

---

[18] Ibid. Berry, page 36.
[19] "The Agenda : Inside the Clinton White House" by Bob Woodward, Simon & Schuster, New York, 1994

Financial Markets

What moves the markets ?

That intriguing, complex question cannot be answered easily when related to the Fed and certainly not in a few paragraphs. A revealing comment on the mindsets of traders on Wall Street came from Alan Blinder who states that "markets have minds of their own and often move dramatically for reasons that have nothing to do with monetary policy."[20] He cites how on two separate occasions, involving expectations of how Federal funds rate would go as the Fed began tightening monetary policy in 1994, "the markets got it wrong - once on the high side and once on the low side." A more troubling point about the relationships between Wall Street, Main Street (middle America) and Washington was made by Stuart Eizenstat, currently Under Secretary of State, while working as President Jimmy Carter’s director for domestic economic policy. "Washington doesn’t understand interest rates, and Wall Street doesn’t understand Washington," he said.[21]

Even though the statement was made more than twenty years ago, recent conversations with senior bond traders in New York and monetary officials in Washington, including at the Fed, show that there still is some truth in it. Many make the point that since the 1970s, Wall Street and Main Street have, if anything, drawn much closer together. Very few with whom this question was raised in recent interviews share the controversial thesis put forth by William Greider in his impressive 1987 book that "the financial market that the Federal Reserve cared about most respected and even identified with, was the bond market."[22] He concludes that the Fed caters, above all, to those representing the highest income groups in the United States, representing about 1% of total household incomes.

Greider’s argument that the bond market matters most to the Fed has been widely challenged. However, it is no revelation to specialists to note that what the Fed may be planning, and how it may influence the economy is intently analyzed and talked about on Wall Street for purposes of trading in a highly sensitive financial market. In other words, perceptions become - and, in fact are - a vital part of accountability.

Meantime, it must be noted, but not usually shouted from the rooftops of Pennsylvania Avenue, notably few Congressmen and even former occupants of the White House truly understand what David Jones describes as the Monetary Policy Transmission Process. (MPTP).[23] Making the point that monetary policy is more art than science, "a process of trial and error, observation and adjustment", he states that it can take anywhere between six to twelve months or more for any given shift in monetary policy to work its way through the financial system. How does the system work ?

---

[20] Interview with the author, Princeton University, October 16, 1998.
[21] "Secrets of the Temple : How the Federal Reserve Runs the Country" by William Greider, Simon & Schuster, New York, 1987, Page 23.
[22] Ibid. Greider, Page 33.
[23] "Modern Central Banking Policy and Practice : An Analysis of the Contributions of the Greenspan Fed", Lecture at Middlebury College, by Dr. David M Jones, July 2, 1998.

The Fed's MPTP today works through capital market asset price adjustments (bonds, stocks, commodities) and, as in the past, the Fed initiates a policy shift by changing the amount of bank reserves. Normally there is, Jones states, a resulting change in the cost of funds as reflected in a change in the funds rate, as we previously explained. And it is this change that is normally followed by a change in the same direction in short term market rates "resulting in an increasing (decreasing) cost of short-term credit, including bank loans made at the prime rate and funds raised in the commercial paper market."

Jones goes on to point out that from an investment standpoint, when the Fed becomes more restrictive, investors holding short-term credit market instruments like Treasury bills, will find interest rates on their short-term investments moving up higher and to more attractive levels relative to yields on longer-term bonds. Thus, he concludes, "investors will shift their investments down the yield curve by selling longer-term bonds and placing the proceeds in shorter-term money investments, resulting in rising longer-term interest rates." Longer term price stability, meaning low inflation, Jones and most economists today agree, is crucial for encouraging productive economic growth. As we shall see, the Clinton White House and Greenspan's Fed have, from the beginning of their relationship, shared this perception.

Does it, then, provide the answer to the next question ?

QUESTION 5 : WHY HAVE THE FED'S STRONGEST CRITICS BEEN UNABLE TO SIGNIFICANTLY CHANGE THE WAY IT OPERATES ?

> "Members of Congress have a way of posturing themselves, and the Fed is an easy target. In previous periods of our history, as doing the Volcker years, the Fed becomes a whipping boy."
>
> Leon Panetta, formerly White House chief of staff

Having held that position close to Clinton for four years until January 1997, and for sixteen years previously represented California in the House, including as chairman of its influential budget committee, Panetta was being both realistic and indulgent. During a recent interview, he made the point, echoed by others, that populist, would-be Fed reformers like Barney Frank and Tom Harkin have generally concentrated their attacks on the Fed's monetary policies, less on the way the Fed operates. Few, if any, have seriously proposed that Congress take back the powers it delegated to the bank originally.

There are five basic reasons.

- First, the political support from colleagues sought by Frank, Harkin and others, has never materialized sufficiently to convert their proposals into law. In April 1997, for example, as the Fed was raising interest rates, Frank and 24 fellow-Democrats on the House Banking Committee, wrote Chairman Leach demanding public hearings on the bank's operations. They proposed the hearings be conducted separately from the semi-annual Humphrey-Hawkins hearings that usually focus on the state of the economy, and the Fed's monetary projections. The answer from Leach, representing the Republican majority on the Hill, who greatly admire Greenspan, was a flat no.

In an open letter, Leach conceded that "Fed policy should never be immune from criticism," but when Congress "tampers" with the bank's independence, it does so "at its peril". He concluded that it would be "ill-advised to rush to judgement and that the most appropriate time for the Committee to express its perspective on monetary policy is the next regularly-scheduled Humphrey-Hawkins hearing," thus quashing an emerging attempt to restrict the Fed's operations.[24]

A glance backward reveals a similar trend. Of the 200 legislative proposals, made between 1979 and 1990, hearings were held on only 50 bills. Only 34 bills were sponsored by more than one legislator and of these, 24 had only three or more sponsors. Thirteen bills proposed to place the Treasury Secretary back on the FOMC, also with weak support.[25] The reason they failed to win significant backing was that contrary to critical statements, or as Panetta said "posturing", Congress did not really want the responsibility for running the nation's monetary policy. This surfaced dramatically during the 1980s when, as we shall see, the attacks on

[24] Letter to Congressmen Barney Frank and John LaFalce, April 17,1997.
[25] Ibid. Federal Bank of New York. p.20.

Volcker and the Fed reached their peak, prompting a former senior Fed official quoted by Greider to declare that Congress "doesn't want to control the Fed...neither Congress nor the President want to take the rap for high interest rates."[26]

- The second reason the attacks have failed stems from the sheer, vastly-complex nature of monetary policy. Some American presidents, and more Congressmen than can be counted, have been simply baffled and frustrated in their attempts to understand and, above all, to deal with the dizzying, technical aspects of money supply, the markets and statistical projections. The title of William Greider's book - "Secrets of the Temple" - captures the flavor of the problem he describes in flowery prose as the Fed's "awesome powers that were shielded from the scrutiny of ordinary mortals, yet seemed to govern their lives like the temple incantations of ancient priests who interpreted divine messages and decreed the course of social destiny."[27]

Since American presidents qualify as "ordinary mortals", it is worth noting that Greider claims that former President Nixon once admitted that one of his greatest regrets was never having "mastered" what the Fed did and how it really operated. Former President Jimmy Carter, who likewise had conflicts with the Fed, was far more sanguine, but also voiced his frustration, noting "it (the Fed) is like the judicial system. I don't have influence on it, but that doesn't mean I have to sit mute." A former Fed governor, Nancy Teeters, previously chief economist for the House Budget Committee, is quoted by Greider as noting how, on Capitol Hill, "I was always amazed at the level of support for the Federal Reserve. It was partly because the way we operate is so arcane, they don't understand it."[28]

We shall be looking at three Fed chairmen, but suffice it to say here that, as a general rule, their sophisticated knowledge and backgrounds are world-class, perhaps shedding light on what Teeters observed. At the top, there is club spirit, as in academia, where previous, deep immersion in formal academic training is considered indispensable. Thus, one, well-informed Fed watcher recalls that when current Governor Edward Kelley joined the board in 1990, some eyebrows were raised at the Fed about his academic background - he was awarded a B.A. degree in history from Rice University and an M.B.A. degree from Harvard University Business School. Most of his management career was spent in manufacturing industries, while serving as a director of three banks. So where was the problem ? "No Ph.D. !" the watcher source said with a laugh.

- A third reason is that when it comes to significant decisions, the Fed keeps a low profile, or no profile at all - when it chooses. We shall examine the Fed's relations with the media, but here it might be worth recounting this writer's experience on October 15, 1998. Interviews with senior Fed officials, including a governor, had been arranged months earlier by the communications department. The background talks began at 1430 hours sharp in the main, marble-white building on Constitution Avenue. Escorted down the long corridors that expressed elegance and spaciousness, I was struck by the calm and quiet. Not until around 1800 hours, getting ready to leave, did I realize something important had happened. No one during my talks even hinted that just after 1500 hours the Fed had announced another drop in

[26] Ibid. Greider p. 474.
[27] Ibid. p. 52.
[28] Ibid. p.163.

the discount rate from 5 percent to 4-3/4 percent and a fall in the federal funds rate from around 5-1/4 percent to around 5 percent, representing a major event in the monetary world.

Even more surprising, in the several hours prior to my meetings, neither Fed-watching colleagues, nor a very senior White House official with close links to the Fed revealed they had any sense of what was being planned for later that afternoon. Indeed, even though market analysts had anticipated, even urged, the cuts, the decision surprised, and, according to the front-page New York Times article October 16, "stunned" Wall Street, which responded with a powerful rally that immediately boosted stock prices, and created a consensus that no credit squeeze was coming in the American economy. Secrecy surrounding the deliberations, and the way in which Greenspan dealt with the move outside of the regular FOMC meeting, were essential ingredients in the positive reactions from the markets. It is difficult even imagining Congress mounting, much less running, such an operation successfully.

- A fourth reason why the Fed appears out of reach stems from its unique financing. Virtually all federal government agencies are subject to Congressional appropriations. Not the Fed. Ten bills were proposed in the 1979-1990 period to bring the Fed under the Hill's control and three more would have placed the bank on the President's budget, thus subject to Congressional control. These measures also died, mainly because the Fed is a big money earner for the government. Consider the following.

In 1997, the latest period for which figures were available, the Federal Reserve System incurred an estimated $1.1 billion in net operating expenses. Total spending of an estimated $2.2 billion, however, was offset by an estimated $1.1 billion in revenue from priced services, reimbursements and other income. The major source of the Fed's income is earnings on the portfolio of U.S. government securities in the System Open Market Account, estimated to be worth $25.7 billion in 1997. In that year, to the satisfaction of the government, earnings in excess of expenses, dividends, and surplus totaled $20.7 billion. What happened to the money ? The funds were, and are, transferred directly to the U.S. Treasury.[29] "The amounts involved are hardly negligible...we in the executive branch probably could not handle it in a better way," a senior administration official said.

- Finally, there is a wide consensus that, leaving aside interest-rate issues, the Fed is indispensable for protecting the nation's banking system. Average Americans now retired still recall vividly the collapse of banks during the 1930s, businesses going under and the like, and many to this day credit the Fed for saving the system from total collapse. As a result of many reforms implemented over the years since the Depression, the Fed not only provides an elastic currency today that expands or shrinks as conditions dictate, but runs what is widely regarded as an efficient and equitable check-collection system.

Today the American payments system is the largest in the world, handling trillions of dollars in transactions each year. In particular, responding to mandates of Congress, the Fed over the years has become an active intermediary in clearing and settling inter-bank payments. And the Fed plays this role because its network maintains reserve or clearing accounts for the majority

[29] Annual Report : Budget Review. Board of Governors of the Federal Reserve System, Washington, D.C. April 1998.

of depository institutions. Consequently, they can settle payment transactions by debiting the accounts of the depository institutions making payments and by crediting the accounts of the institutions receiving payments. The Fed system also has the monumental responsibility for making sure enough paper currency and coins are in circulation to meet demand.[30]
Considering that the Fed is regularly audited by the GAO, the investigative arm of Congress - but not covering monetary policy operations nor transactions with foreign governments, central banks and governmental international financing organizations - it should come as no surprise that neither Congress, nor the White House wants to take over from the Fed. Public opinion, moreover, is generally satisfied and apathetic about day-to-day operations. "Most people are not aware of all we do here, such as running the payments system...it’s a bit like operating utility grids," commented a senior Fed official.

[30] Ibid. Federal Reserve System. pp.94-95.

QUESTION 6 : WHAT ACCOUNTS FOR THE MEMORABLE IMPACT OF WILLIAM MCCHESNEY MARTIN, JR.?

> "Crucially, Chairman Martin moved the Federal Reserve from being an adjunct of the Treasury Department to the independent status we know today."
>
> Alan Greenspan, Chairman of the Federal Reserve System

Greenspan uttered those admiring words in late July 1998 shortly after the death of Martin at the age of 91. The life of this unusually strong, discreet and audacious Fed chairman, whom New York Times columnist James Reston once called "the happy puritan", is worth examining, if only briefly, for three reasons :

. No chairman has ever served as long - a total of 19 years, with five presidents : Harry Truman, Dwight Eisenhower, John Kennedy, Lyndon Johnson and Richard Nixon.

. He presided over the Fed during a truly golden era, encompassing the nation's longest period of economic expansion : 1961 to 1969.

. Two famous phrases reflected his pioneering approach to the Fed's accountability : "leaning against the wind", a sailing term, and his role as the person who, as he said, had "to take away the punch bowl just when the party gets going".

How did he get there?

Greenspan's recollection was apt. At the time Harry Truman approached him, having just edged out Thomas McCabe as Fed chairman, Martin had been the Treasury Department's chief negotiator on the agreement reached with the Fed. The Treasury at the time was fighting not only the strains on the economy of the Korean War, but a "rearguard action" to keep as much influence over the Fed as possible.[31] Martin's role as a highly-talented Assistant Treasury Secretary convinced Truman, a fellow Missourian, that this would-be Fed chairman could be counted on - that is, to follow orders. The president, who occupied the White House from 1945 to1953, quickly discovered there was more to his candidate than met the eye.

According to one account, when Truman was interviewing him about taking the chairmanship, he recalled having purchased Liberty Bonds, floated to help finance U.S. participation in World War One, and that they had later declined in value. "You wouldn't ever let that happen again would you ?" Truman asked. The plain-spoken Martin, who in his youth had toyed with the idea of becoming a Protestant minister, told the president that, of course, he did not want a repeat, but that if the Administration did not follow responsible fiscal and monetary policies, the same thing could indeed happen again.[32]

Seventeen years later, a just-elected President Richard Nixon thought he could immediately name a new chairman. However, Martin, according to various accounts, told the new

[31] Ibid. Berry p. 37.
[32] The New York Times obituary by Melody Petersen provides an excellent, thumbnail description of Martin's career. July 29,1998. Page A6. As does the obituary of the Economist August 8, 1998. Page 77.

occupant of the White House that his term did not expire for another two years, and that he fully intended to serve until it ended. Nixon was not pleased, to say the least. He blamed the Fed for having caused a recent slowdown, Nixon believed, by the Fed's tight-money policy, or what Martin earlier had described as "leaning against the wind", a sailor's navigational maneuver.

Until the end of 1965, the sailing had been smooth, and hardly anyone questioned the Fed's accountability. Similar to the 1920s, on the eve of the Depression, and in some respects, the situation in 1999, there was a widespread conviction that the American economy could enjoy steady growth without significant inflation - indefinitely. One presidential advisor proclaimed the business cycle obsolete. Not Martin.

Amid the Vietnam War, growing signs of inflation appeared. Martin had already gravely warned Congress about its approval of increasingly heavy spending and looming deficits. In December 1965, Martin decided it was time to act - with a sharp rise in the discount rate. This was the first, major pioneering demonstration of his "leaning" strategy that involved easing the Fed's stance during slow periods of growth, and tightening when the economy was expanding too fast, prompting David Jones to describe him as "the all-time master of the art of central banking".[33]

Nixon's predecessor, President Johnson, protested vigorously about the Fed's plans to tighten and, according to several, similar versions of the incident, the president invited the chairman to his ranch in Texas. Reportedly, he drove Martin around the grounds in his jeep, berating him for his stance while driving, gesturing and clearly angry and determined. Martin would not budge. His job was, as he quipped, to remove the punch bowl just as the festivities - meaning even more dangerously-expansive growth - was getting underway. And thus rates, as promised, rose.

Did anyone really understand what was happening ? When he took office - let us recall that was in 1951 - Martin said in a newspaper interview many years later : "I'm not the brightest fellow in the world, but I'm working hard on this - and I haven't the faintest idea of how you figure the money supply...they (Washington policymakers) don't really know what the money supply is now, even today. They print some figures - I'm not trying to make fun of it - but a lot of it is just almost superstition. "[34] It sounded like Nancy Teeters.

You can't take it with you

As we move toward the stormiest period of the Fed's postwar history - the Volcker era - it might be worth noting a phrase repeated time and time again by governors and their predecessors interviewed for this report - entering the world of the Fed means leaving your partisan politics at the door, even if the appointing president is of the same political persuasion.

---

[33] Ibid. David Jones lecture July 2,1998, which provides a useful analysis of Martin's strategy.
[34] Ibid. The New York Times obituary.

"It isn't just a matter of monetary policy, but to whom we as governors are responsible - and it is to the American public, the stability of the American economy as a whole," one of them said, "and it is this role, this culture at the Fed one assumes when becoming a governor." Most of those interviewed agree with the observation of Lyle Gramley, a former governor and currently consultant to the Washington-based Mortgage Bankers Association : "the institution, the Fed in this case, shapes the man."

While this could also be said of other institutions, it should be noted that governors, and particularly chairmen, do not wind up in those jobs by accident, nor, generally, because of their political backgrounds. Consider Martin. His father was a banker, who helped Wilson develop ideas for the 1913 legislation and later became president of the St. Louis, Missouri Federal Reserve Bank. Young William earned his B.A. degree at Yale University in Latin and English, but soon was working at the St. Louis bank as an examiner. In the midst of the Depression at the age of 31, he had become the first salaried president of the New York Stock Exchange. Following World War Two service as a colonel in the Army, he became chairman of the Export-Import Bank and joined the Treasury prior to being named Fed Chairman by Truman.

Intellectually and professionally-equipped to meet the mounting challenges, he regularly, single-handedly confronted one of his most hostile critics - Congressman Wright Patman, a populist, Democrat from Texas who became chairman of the House Banking Committee. Patman repeatedly accused Martin of being controlled by, and accountable to, private banking interests. By remaining cool, pleasant and determined in dealing with Patman and with fellow-Democrat President Johnson, Martin set an example for his successors.[35]

[35] Ibid. Berry. Page 42.

QUESTION 7 : WHAT MOTIVATED AND HELPED PAUL VOLCKER TO SUCCESSFULLY COMBAT DOUBLE-DIGIT INFLATION WHILE PRESIDING OVER A RECESSION ?

> "Senator Donald Riegle : I think the Fed has an obligation in its own right to face up to the damage caused by the high-interest-rate policy.
> Mr. Volcker : I do not think the Federal Reserve is being stubborn in this area. I think we have a very difficult problem. I would be delighted to see interest rates decline, obviously...
> Senator Riegle : You do have something to do with that. I mean, in all honesty, it is not as if you are a helpless bystander.
> Mr. Volcker : It is perhaps not quite as simple as you imply, senator."
>
> Quoted in William Greider's *Secrets of the Temple*

The Inquisition

At the time this particular Senate hearing was being conducted - and others like it in 1981 and early 1982 - the nation was in an uproar over how to respond to the combination of high interest rates, average price-rise levels just under 17%, and unemployment levels of around 11%. A highly-popular President Ronald Reagan was at the White House, having soundly defeated his predecessor, Jimmy Carter, and the "very difficult problem" referred to by Volcker was nothing less than one of the worst recessions in decades.

Indeed, he was the man in the middle, and, as we saw earlier in this report, was the target of many attacks on Capitol Hill. "Republican and Democratic, liberal and conservative took the opportunity to denounce his imperiousness or plead with him for relief...Volcker ducked and dodged stoically, repeating the same bromides over and over again."[36] In another typical exchange on Capitol Hill, Volcker conceded that interest rates were "extraordinarily high" and that he fully expected them to drop. Yes, yes, but when? several angry congressmen asked repeatedly, He brushed off the questions, calmly replying he could not be more specific for the time being.

Around the country, the reactions to what the Fed was doing were no less persistent and often anything but polite. The Fed's restrictive policies forcing up interest rates drew strong, steady, sometimes violent reactions, much of it from representatives of industries that were being hit hardest, such as the building trades and the automobile sector. Volcker's life was occasionally threatened during this period, accounting for the unprecedented decision that he accept 'round-the-clock protection. This followed an unsuccessful, forced entry at the main Fed building in Washington by a man armed with weapons who, although described as

[36] Ibid. Greider pp. 471-472.

"distraught", was determined to draw public attention what many believed the Fed was doing wrong. An associate of Volcker, quoted by Greider, noted that the public criticism was "really abusive", and that "it was hard on him". If so, the tall, lanky, cigar-smoking Fed chairman did not show it in public. Rather, many observers remarked at the time, he reflected a serious, caring fatherly image and attitude who was doing what he thought best for the family - that is, the American people and their economy.

One of the communications problems was that few Americans understood what he, with the full support of the FOMC, was doing specifically - namely, tackling inflation not, however, through the traditional means of adjusting changing funds and discount rates, but by targeting and adjusting the money supply, specifically M1. This is one of three, main monetary aggregates that can be directly influenced by the Fed, comprising mainly currency and checking deposits. Although colored by a "certain dogmatism", the changed approach was Volcker's decision, and, to the surprise of many observers, was understood and shared by Reagan.

The president had been greatly influenced by Milton Friedman, the eminent founding spokesman for the monetarist doctrine, and who had convinced the president that the best way to combat inflation was to slow, or stop, the production of money.[37] Washington's strategy was, above all, a response to the "stagflation" of the 1970s, which required, and was based on, what Alan Greenspan, Volcker's successor, described as a "thorough conceptual overhaul of economic thinking and policymaking".

At the time, Greenspan, a rising, conservative Republican advisor to Reagan, seemed to have approved of the course. Based on his more recent statements, he had clearly become part of the bipartisan consensus that had already emerged in the late 1970s, under the Carter Administration, affirming that inflation destroyed jobs and certainly could not create them. "Monetarism, and new insights into the effects of anticipatory expectations of economic activity and price setting, competed strongly against the traditional Keynesianism" as an antidote, Greenspan recalled.[38] But Volcker needed no convincing.

Nurturing Volcker

While still an undergraduate at Princeton University, majoring in economics, he wrote his senior essay on the history of the Fed since the end of World War Two. His research led him to the conclusion that since the end of the war, the central bank had lost its ability to significantly influence the flow of money and credit. Therefore, he concluded, either monetary discipline had to be imposed, or the country would face continuing inflation. As the son of a senior administrative official from a small town in New Jersey, Volcker also firmly believed in the separation of governance and partisan politics, and the necessary commitment of government officials to public service.

---

[37] A good discussion of monetarism is contained in "Monnaie et Economie : Chronique de Politique Monetaire Etats-Unis-France", Christian de Boissieu, Economica, Paris 1998 ; pp 17-29.
[38] Ibid. Greenspan speech, December 5, 1996.

His ideas and experience were severely tested over the years, drawing public attention in the early 1970s while he was in charge of monetary policy at the Treasury Department, and a few years later while president of the New York Fed. In 1973, as Nixon phased out domestic price controls and moved away from stabilizing the dollar, the Organization of Petroleum Exporting Countries, OPEC, announced a boycott of crude oil sales, quadrupling their prices. Inflation quickly from just under 9% to over 12%. Like a minority of the FOMC, Volcker argued for countermeasures unsuccessfully. While the subsequent recession winding down in 1975 dampened the inflation rate to an average level of less than 5%, the fundamental problem, in Volcker's mind, remained.

By 1978, a year before he was confirmed by the Senate to head the Fed in Washington, Volcker was warning Carter about "uncertainties", urging tighter policies to confront looming inflation. Within a year, OPEC had re-doubled oil prices and, once again, Volcker was arguing for even stronger anti-inflationary measures, this time with plenty of support from leading economists in and around the White House and around the country. Indeed, when in 1979 it became clear that Carter had decided on Volcker to head the Fed, both the stock and bond markets rallied, amid widespread claims that he was "the candidate of Wall Street." As he took over, Volcker committed himself to a monetarist approach - rigorously controlling the money supply - thus breaking with the Fed's traditional approach to tackling inflation. Greider's book provides behind-the-scene accounts of how this period unfolded and explains why Reagan monetarists refused to believe that Volcker was sincere and converted to their doctrine.[39]

His reference to David Stockman, Reagan's budget director, is noteworthy, because it highlights the surprising point made earlier Reagan seemed to have a better grasp of what Volcker was doing than most of his advisors, who were constantly sniping at the Fed chairman. "He (the president) could take a piece of paper and draw a line tracing the money-supply growth all the way back to the sixties. He had one thing that he knew and he always made the same point about the Federal Reserve. The money supply zoomed in every election year, flooding the economy with money, and then, after the election, the Fed pulled the string and the economy went into recession," Stockman said of Reagan's grasp of the process.

Ex-governor Lyle Gramley, who served during this period, is convinced that Reagan's support for Volcker's crusade against inflation was a deciding factor in his success as a central banker. "Had the president not stood up for Volcker during this period, it might have turned out differently," Gramley said in an interview. "He knew that it (inflation) was not a good thing, and thus supported his Fed chairman at a very critical time."[40]

[39] Ibid. Greider in Chapter "A Car With Two Drivers".
[40] Interview with the author, Washington, D.C. October 16, 1998.

QUESTION 8 : WHY AND HOW HAS ALAN GREENSPAN REMAINED SO POPULAR?

"Visionary Alan Greenspan : An Unlikely Guru"
Business Week August 31, 1998

This headline on a revealing profile made a point that few average Americans and even congressmen had grasped : the brainy, somber Fed chairman was converting from being an inflation hawk to one who now was convinced that growing, substantial investments in new technologies will allow the American economy to grow faster and longer with a reduced risk of inflation. His greatest legacy, suggested the reporter who covers the Fed, "will be a high-growth, low-inflation economy."[41]

What happened to inflation ?

Few would disagree today that if one central player on the scene at the time should be credited with working inflation out of the American economy, it would be Paul Volcker. Many others, including those in the Reagan and Bush administrations, and those business leaders pursuing massive, corporate restructuring, also played determining roles. And even though the U.S. inflation rate currently is projected at only 1.2% in 1999 and at 1.8% in 2000, it was only as recently as last spring that stock prices fell sharply around the world on reports that the FOMC decided to signal the markets that a rate increase might be coming, in response to what "Federal Reserve officials" were quoted as having described as "inflationary pressures".[42]

As we know, there were no rate increases last summer ; the FOMC in fact lowered rates several times in subsequent months. But it is worth noting that neither Greenspan and his allies on the board, nor the White House and those in Congress, could claim unanimous support at the Fed. Pushing for a quick tightening, inflation hawks at the FOMC as recently as last spring cited the following : a recent surge in the money supply, labor shortages throughout the United States, the related growth of wages, and no slowdown in economic expansion. They warned that if no action was taken, inflation might come roaring back.

These so-called dissidents represent only a handful on the FOMC, and all are disciples of monetarism who first openly challenged Greenspan last May on a vote regarding rates. "I felt completely comfortable speaking my mind and voting my best judgement," to increase rates, William Poole, president of the St. Louis Fed said in an interview. Following him in the dissent was Jerry Jordan, president of the Cleveland Fed, both voting members of the FOMC, amid widespread speculation that the outspoken Poole, with the support of at least one more like-minded board member, could lead a "monetarist revival".[43]

---

[41] Business Week ; August 31,1998 page 31.
[42] Semi-Annual Outlook Report, Organization for Economic Cooperation and Development, Paris, November 1998.
[43] Business Week, July 27, 1998.

Two reasons explain why they failed to convince other FOMC members - the performance of the economy and Greenspan's sense of accountability. In a reflective, visionary speech at Berkeley in September, he immediately conceded that in the early summer there was indeed concern that "a rise in inflation was the primary threat to the continued expansion of the economy." But, in the meantime, the risks had become "balanced". In the future, the FOMC will need to carefully weigh the "potential ramifications of ongoing developments," he said, moving on to the major theme of his talk built around the question : is there a new economy ?[44]

No single phrase in the talk received as much media and market attention as the line : "it is just not credible that the United States can remain an *oasis of prosperity* unaffected by a world that is experiencing greatly increased stress." This was a clear reference to the financial crises and looming dangers in Asia, Russia and Latin America, and it raised the prospects of a looser Fed monetary policy. But that wasn't the essential issue Greenspan was addressing - how the American economy was being positioned for the next century.

The answer he suggested was complex, obtuse and not exactly headline-grabbing. "My experience of observing the American economy day by day over the past half century suggests that most, perhaps substantially most, of the future can be expected to rest on a continuum from the past." In other words, his answer to the question about the much-debated new economy was negative. "As in the past, our advanced economy is primarily driven by how human psychology molds the value system that drives a competitive market economy. And that process is inextricably linked to human nature, which appears essentially immutable and, thus, anchors the future to the past."

His conclusion? Noting that the past seven years have delivered "one of the best economic performances in our history," he predicted that only with the "inexorable passage of time" will an answer be found and that the new, younger generation of leaders "will be periodically debating whether they are in a new economy."

Decoding An Icon

At his confirmation hearings in July 1987, a skeptical Senator William Proxmire of Wisconsin, the liberal Democratic chairman of the Senate Banking Committee, and who had voted against Greenspan to chair the Council of Economic Advisors in 1974, asked : "are you the man who can say no to the president and the Congress ?" Greenspan's response : "Certainly. I will be taking an oath of office, and I take that very seriously...it would not be credible to adopt a monetary stance other than that indicated by economic and market conditions." Within several months of having been sworn in as chairman, he was asked why his responses to questions so often seemed evasive, unclear and sometimes resembled, well, mumbling. His witty response : "Since I've become a central banker, I've learned to mumble with great coherence. If I seem unduly clear to you, you must have misunderstood what I said."[45]

---

[44] Greenspan speech, University of California, Berkeley, September 4, 1998.

[45] "Back From the Brink : The Greenspan Years", Stephen Beckner, John Wiley, New York, 1996 pp. 27 and 18.

More people than can be counted have tried hard to understand what he means when he speaks in public. Here is the nation's well-known, Republican economist chairman of the Fed, regarded by many as the second most-powerful official in the United States after the President. At 72 years of age, in his third term that runs until 2000, he is viewed by some as being everything from a visionary, national guru and a genius to an icon. Yet, Greenspan is not easily fathomable. Bob Woodward, in his excellent book on the early years of the Clinton presidency, describes him as follows: "Dressed like a 1950s intellectual, he walked slowly, with a slight stoop, giving off a sober, sometimes gloomy air. Greenspan spoke in a weary drone with an overly abstract precision, elevating Fedspeak, as the jargon-filled language of the Federal Reserve was often called, to a higher form all its own: Greenspanspeak."[46]

Most writers and journalists agree that he is not an easy person to decipher, for as Richard Stevenson, who covers the Fed for the New York Times, recently noted: "He rarely answers questions directly. Economists, investors and politicians have been trying to read his mind ever since he was appointed" by President Reagan to succeed Volcker in 1987. That observation may be correct, but a careful reading of his speeches and Congressional testimonies does provide a lot of useful background for assessing his behavior and his sense of accountability.

Stevenson, who, along with John Berry of the Washington Post, is one of group of highly-knowledgeable journalists following the Fed, recently described Greenspan's approach as "fiercely intellectual and dispassionate. He rarely gets out to factory floors, or fast-food kitchens and, except in occasional visits with labor leaders, rarely seems to interact much with anyone but the élites in government, economics, business and finance...the sheer breadth of Mr. Greenspan's data-gathering has always dissuaded him from relying on a particular forecasting model or rule-driven approach to monetary policy."[47] He dazzled Margaret Thatcher with his detailed grasp of the American economy ; at one meeting, the feisty prime minister reportedly quipped, nastily, to her then-governor of the Bank of England, Robin Leigh-Pemberton, that it was a pity he wasn't as knowledgeable about what was happening in the British economy.

Numbers, tennis and inflation

Son of a stockbroker, raised in New York City, the young Alan was shy and had an unusually strong capacity for numbers, able to add three-digit numbers in his head at the age of five.[48] That talent was to help him enormously later in life. However, when it came to improvising jazz - he played the clarinet and tenor saxophone and, for a year, with a swing band - he wasn't nearly as good when reading music. He learned to play tennis in his youth, which would also provide a strong asset once he began moving in influential circles in Washington.

[46] Ibid. Woodward. Page 64.
[47] "Safeguarding a Boom and a Legacy" by Richard Stevenson, International Herald Tribune ; November 17, 1998.
[48] A Profile of Federal Reserve Chairman Alan Greenspan, David M. Jones, July 23, 1998. An excellent paper of eleven pages.

After graduating with honors in economics from New York University, he temporarily abandoned work on his doctorate at Columbia University to help launch an economics consulting firm in the early 1950s (He was awarded the Ph.D. some twenty years later). His ideas on the philosophy of economics were strongly influenced by Ayn Rand, the Russian-born writer and intellectual. Devoted to a pure form of self-interest capitalism, and the necessary, predominant role of business leadership, her tutelage developed in Greenspan "an almost visceral aversion to inflation."[49]

Not surprisingly, he felt very much at home in Republican circles. In 1968, he was tapped by presidential-hopeful Richard Nixon as his director of domestic policy research, a crucial decision that propelled Greenspan into the power elite of the nation's capital. In 1974, he was appointed by President Nixon to head the Council of Economic Advisers, a cabinet post and influence he relished, along with a perfected tennis game that made him a regular on the White House courts. Another avid player, Republican President George Bush, named him chairman for a second, four-year term in 1991. The man who relished rock music and fast food and defeated Bush in the following year's presidential election, Bill Clinton , would soon come to terms with the reserved urbane Fed chairman and a key, unanswered question : when it came to monetary and fiscal policy, to whom would they be accountable ?

Making peace and reducing the deficit

In responding to Question 4, we briefly sketched an early meeting in Little Rock of the emerging Clinton administration and their approach to managing the economy. This was just prior to the inauguration in January 1993. The decision by Clinton to come to terms with the looming, large federal budget deficit, the Fed and the bond market, followed a period of intense, bitter, open conflict over monetary policy between Greenspan and several White House advisers and notably with Bush's Treasury Secretary Nicholas Brady, a former investment banker on Wall Street. Beckner's book contains probably the best account of this period. It ended painfully with Brady and Greenspan suspending their traditional, weekly breakfasts, and Brady's open, hostile accusation that Greenspan, with support from the FOMC pursuing a too-tight monetary policy, had caused Bush's defeat in the 1992 presidential election.

Clinton was determined to avoid such conflict and to deliver on his campaign promises, while Greenspan was convinced that short-term rates were at about the right level, but that long-term rights were far too high. They met for the first time in Little Rock on December 3, 1992. An excellent description of that meeting and of their evolving relations, is contained in the Woodward book, indicating how close they were in their ideas and shared sense of accountability. "No longer could Alan Greenspan be so easily distinguished from Bill Clinton...Greenspan thought that Clinton's plans for his administration even resembled President Ford's in the 1976 Republican platform."[50]

[49] Ibid. Beckner. Page 84.
[50] Ibid. Woodward page 71.

After the meeting, Clinton reportedly told vice president-elect Al Gore that they could do business with the Fed chairman, whose term ran through 1995. To Greenspan's surprise on February 17, the day President Clinton delivered his inaugural State of the Union address to Congress, he found himself prominently seated between the wives of the two White House leaders. That gesture became something of a media event for the Washington press corps, which did not displease Greenspan. The White House-Fed relationship was changing rapidly - for the better.

With the federal budget deficit under control, monetary policy responding to the satisfaction - and often the delight - of the markets, plus an expanding economy with low inflation and unemployment, it was no surprise that Greenspan got much of the credit, along with the Clinton administration. There were - and still are - major areas of disagreement, however, notably with regard to banking regulation where Greenspan and Treasury Secretary Rubin are openly at odds over whether the Fed or the Treasury should have the decisive role. But the two leaders still meet regularly for a working breakfast and once a month, FOMC members, including occasionally Greenspan, meet over lunch with Janet Yellen, a former governor, and currently chair of the Council of Economic Advisers, a cabinet post. The meetings are informal, usually with no agenda, but current, controversial issues are discussed regularly, such as prospects for growth and inflation and credit availability and the handling of the LTCM bailout, for example. "No one divulges their secrets, but it gives us all a chance to talk about everything except monetary policy, which is the Fed's only off-limits area for these meetings," one participant said.

Despite secrecy surrounding deliberations, and continuing calls for change from a handful of legislators, it is worth noting that virtually no major criticism was directed at the Fed by the White House, or by the Republican-dominated Capitol Hill when, early on during his tenure, Greenspan dropped the Volcker approach to targeting monetary aggregates only. Instead, he returned to a more traditional, broader way of assessing the nation's economic performance - measuring actual new orders, output, employment, wages, prices, as well as the money supply. "There is, regrettably, no simple model of the American economy that can effectively explain the levels of output, employment and inflation....unfortunately, money supply trends veered off path several years ago," he said later.[51]

It is clear to even his critics on the left, and perhaps the monetarists, that the Fed today and notably its chairman, are striving for something approaching balanced growth of the American economy but have no specific guidelines that are based on the law. Greenspan himself always says that his number-one mission is remaining accountable to the nation for monetary policy, in keeping with the goals cited in the Humphrey-Hawkins law. On rare occasions, Greenspan bares his soul. "I wish I could say that there is a bound volume of immutable instructions on my desk on how effectively to implement policy to achieve our goals...we have to deal with a dynamic, continuously evolving economy whose structure appears to change from business cycle to business cycle... "[52]

[51] Ibid. Greenspan speech December 6, 1996.
[52] Ibid.

Why do so many believe that Greenspan is successful, while remaining accountable to the Congress, the markets, the White House and the media - simultaneously? I put that question to Leon Panetta, who attended that famous Little Rock meeting and who later became Director of the Office of Management and Budget, White House chief of staff until last year and who, over the years, had regular dealings with Greenspan. "The bottom line is that a Fed chairman to succeed, he must be a good politician, and Alan Greenspan is a good politician. To achieve what you think is right, (in Washington) you need to build consensus and this is what he (Greenspan) has also done. All of us (close to Clinton) decided early on to avoid taking on the Fed and so, we developed a good relationship," Panetta said, adding "and, besides, the economy is doing well."[53]

[53] Interview with the author, May 25, 1998, Paris.

QUESTION 9 : WHERE DO THE MEDIA FIT INTO THE FED'S APPROACH TO ACCOUNTABILITY ?

> "There is quite a bit of hype in the reporting about us, often just plain wrong, yet we consider ourselves the most open system in the world. "
>
> A Fed executive

Is this statement accurate ?

The world media not only cover the Fed's decisions and pronouncements of Greenspan as they occur, but spend a great deal of time and energy analyzing and commenting these events before - and after - they occur. Many players are involved, constituting a triangular, tense relationship - the media, the Fed governors, and, finally, those Fed executives responsible for communicating with the outside world.

However, the media are the newcomers and have come into their own as players only within the past decade with the explosion of public interest in the global economy, and in the markets. Thus, the media, in effect, have become a crucial, active link between the Fed and Main Street and Wall Street with mixed results, as the above-cited complaint from a Fed insider who deals with the media indicates.

There is both exaggeration and truth in what the executive said above during a recent interview, echoed by others, including reporters and analysts who regularly cover the Fed for print, and electronic media. They range from news agencies, such as Bloomberg, Dow Jones, Market News, and Reuters ; television networks CNN and CNBC to such publications as The Wall Street Journal, the New York Times and the Washington Post, each of which have at least one reporter assigned to the Fed on a permanent basis. The competition among them is fierce, particularly in Washington, and it surfaces quickly when the Fed is preparing to announce a shift in rates, which sometimes - very understandably - leads to mistakes and exaggerated stories known in the communications business as hype.

Some reporters in the print media believe, perhaps unfairly, that the electronic news agencies relish not only covering informed speculation about rate changes, but watching how their stories move markets that, in turn, are used in marketing their services. Who is responsible ?

Consider the following : On Monday, April 27, 1998, the Wall Street Journal published an exclusive article stating that the FOMC had secretly "adopted a bias" toward raising interest rates at their March 31 meeting, citing "Federal Reserve officials". Since everyone in the media and the markets assumed that the minutes of the FOMC' meeting in March would not be published for up to eight weeks, (they were released on May 21) and since the Fed declined to confirm or deny the report, the players reacted immediately. The following day, front-page articles around the world, citing the report, carried the news of stock prices falling in major markets, and of interest rates rising, depressing bond prices and the inevitable reactions of traders and analysts. Several brushed off the story saying that adopting a bias was not making a decision and at least one leading economist predicted that the FOMC would sit tight, amid widespread concerns, shared by Greenspan as we saw earlier, that there were reasons to fear growing inflation, lending weight to the Journal's article.[54]

Those outside the Fed following the story would have to wait until publication of the 16-page summary of minutes of the March meeting to learn that the economist was correct. With only Governor Jordan voting against his eleven fellow FOMC members, the committee decided that "a somewhat higher federal funds rate would or a slightly lower federal funds rate might be acceptable..."[55] We now know that, within several months, rates were actually lowered three times, and that the guessing would undoubtedly continue in the months ahead. The deliberate leak to the Wall Street Journal underscored two important points often overlooked in day-to-day coverage of the Fed - first, the media strategy in Washington tends to be focused on a relatively small number of news outlets, and two, despite complaints from the media, the Fed is indeed very open, compared to other federal agencies and certainly compared to virtually all European central banks with the exception of the Bank of England.

Greenspan, who in the past five years has led the transparency drive, was responsible for establishing the current system of publishing a detailed summary of minutes with a time lag of between six and eight weeks following a regular meeting. The minutes are routinely available to the media and the public, and according to writers who have compared them with the full transcripts, routinely published after a lag of five years, they are very close in the information they contain - names of those attending, detailed analysis of the economy, what was decided with the rundown of how each governor vote ; dissenting votes are usually explained, citing the dissenter's views. While important and a great improvement over earlier practices, it is but the tip of the iceberg, for as Greenspan explains : there remain "certain areas where the premature release of information could frustrate our legislated mission...to open up our debates on monetary policy fully to immediate disclosure would unsettle financial markets and constrain our discussions in a manner that would undercut our ability to function."[56]

The accounts of FOMC meetings, as well as the thirty or forty times each of the governors testify on Capitol Hill annually, and which are routinely carried live by the C-Span television channel also contribute to the flow of information to the media. Speeches, primarily by the chairman, as we have seen previously, attract considerable media attention as well. Some meetings of the Fed Board are open to the public in Washington, but not those dealing with monetary issues. Open to the public are Fed meetings dealing with banking regulation, for example, even though attendance is usually by lobbyists and a handful of reporters, depending on the topic under discussion.

While Greenspan avoids news conferences and regular briefings with the Washington press corps as a whole, he often talks with reporters and news analysts he knows on a background,

---

[54] International Herald Tribune, "Hint of Rise In U.S. Rate Hits Stocks Worldwide", April 28, 1998.

[55] Minutes of FOMC meeting, Federal Reserve Board, Washington, May 21, 1998.
[56] Ibid. Greenspan speech December 5, 1996.

non-attributable basis. "Compared to other parts of the government I cover, the Fed is not exactly open," commented a well-known and seasoned national television reporter, adding that "virtually no one listens" to the speeches and testimony delivered to Congress by Greenspan and other governors. Indeed, in most articles or televised reports dealing with a Fed policy move, the largest share of the content reflects reaction and analysis from traders, bankers, economists and, occasionally, former Fed governors, most of whom have little more hard information than the journalists, but do provide experienced insight.

This relatively restrictive approach to communications may explain some, but by no means all, of the complaints heard from Fed officials about some of the journalists they deal with - that they are inexperienced, or too young ; often reach for stories about the Fed, leading to hype, speculation and inaccuracies referred to earlier. What cannot be eliminated in communications strategy is the so-called time lag problem, particularly when dealing with the media coverage of monetary policy and its impact on the American and world economies an for one reason : it takes anywhere from between one to two years for a significant change in policy to work its way through the system. The response in Greenspanspeak is the following : "because monetary policy works with a lag, we need to be forward looking, taking actions to forestall imbalances that may not be visible for many months."[57]

[57] Ibid.

QUESTION 10 : CAN THE FED PROVIDE ANY LESSONS FOR OTHER DEMOCRACIES?

> "1998 may be remembered as the year in which the power of central bankers reached its zenith. They should enjoy their moment of glory : it will not last. "
>
> *The Economist*

This reflective article on the future of central banks is worth reading.[58] It puts forth the thesis that the power and glory of central banks is receding, and asks the provocative, troubling question : would the Western world be better off without them ? The writer suggests the answer may be a qualified yes , noting that in 1900 only 18 countries had central banks, compared to 172 currently. The article cites three major criticisms of central banks, which it does not identify, that may lead to their demise :

. Central banks focus too heavily on fighting inflation, targeting price stability only, and not enough on generating output and jobs.

. Central banks lack transparency and accountability, and thus risk becoming a scapegoat in future economic crises.

. Central banks measuring inflation do no pay enough attention to prices of financial assets, traditionally excluded from consumer price indexes.

The main purpose of this paper was to explain the Fed's accountability, not to compare the Fed with other central banks, much less to argue for freer, private banking as The Economist suggests. Therefore, responding to the questions related to the Fed's historical role in being accountable and, indirectly, to those raised by The Economist, it might be useful to summarize the main findings of this report.

1. The establishment of the Fed, compared to the relatively-recent origins of the ECB, was a long and controversial process dating from the earliest days of the creation of the United States. The controversy between modern, pragmatic policymakers and traditionalist, populist legislators, while still present and simmering, has virtually disappeared in nationwide discussions about the Fed and the way it operates. While in a minority, the populists have, nevertheless, triggered important reforms, which are unique to the American political environment.

2. Again, in contrast to the experience of Europe and the ECB, the Fed is a creature of Congress. And as guardian of the American people's will, it maintains the constitutional power to rescind the bank's founding legislation. This explains the indirect controls Congress exercises through mandatory, public hearings, and regular auditing. And yet, the Congress wants the Fed to remain independent of the administration and other, direct political pressures, which explains the checks and balances built into the Fed's structure.

3. Independence and accountability are related, but separate concepts. They represent an approach that strives to balance responsibility, stemming from Congress's will, accepted

---

[58] "The Central Banker as a God", The Economist, 14 November 1998, pp. 21-28.

by the majority. Because of nearly eight years of steady, economic growth, this approach has not been challenged. However, by recalling the Volcker era, it becomes obvious that in times of economic recession and-or high inflation, the system has - and may again - come under enormous strain.

4. The Fed's sense of accountability extends well beyond Washington. It is a distortion of reality to say today that Washington does not understand interest rates, particularly under Clinton. The Fed and the administration are keenly aware of the needs and roles played by the markets ; governors have a mission to remain in touch with the main actors in the nation's business community, including through established, consultative committees.

5. Defending the bank's mandate vigorously, fearlessly, is a key role of the Fed chairman and the governors, even if they do not always agree on the policy to be pursued. Most often, the traditional adversary has been the White House, particularly in difficult times, such as the 1980s. Even in the current period, Greenspan and Rubin disagree strongly over issues related to banking regulation. The different, assigned roles explain why there is virtually no support for putting the Treasury Secretary back on the FOMC.

6. In the present context of a robust economy and a high level of competence at the Fed for monetary policy, there are no signs of a viable alternative to the present system. No one in Congress, nor at the White House, wants to take over the Fed's responsibilities, although this is usually said in private. The bank's harshest critics have spent most of their energies publicly attacking the Fed's monetary policies, not the way it operates.

7. Banking regulation and operating the nation's large payments system remains a large, often overlooked aspect of the Fed's activities, and for which the Fed considers itself highly accountable. As a result of the multitude of operations conducted by the Fed, considerable revenue is generated that is then paid to the Treasury. Not only does this satisfy a need for government income, but it assures the Fed financial independence of Congress.

8. There is another, unquantifiable dimension to the Fed's sense of accountability which is rarely disclosed in speeches or other official statements. It is the sense of personal obligation among governors to do "the right thing" for the economy as a whole in the interests, ultimately, of the largest number of citizens. This was demonstrated in the recent rate decreases, reflecting great concern for the new uncertainties created by the Asian crisis and the need to shift the priority in monetary policy away from fighting inflation.

9. The media has come to play a dynamic force in the accountability of the Fed, acting both as the transmission belt for 'round-the-clock information, and a platform for analysis and debate. However, differences continue to fuel debate over how well, and how poorly, the media does its job in covering the Fed and the impact of its decisions on the economy. Secrecy of deliberations and limited access for the majority of journalists remain. There is agreement, however, that the Fed is probably the world's most open and transparent central bank.

SELECTED BIBLIOGRAPHY

Stephen Beckner, *Back From The Brink: The Greenspan Years*, New York, John Wiley, 1996.

Alan S. Blinder, *Central Banking in Theory and Practice*, Cambridge, MIT Press, Mass. 1998.

Christian de Bossieu, *Monnaie et Economie : Chronique de Politique Monetaire Etats-Unis-France*, Paris, Economica, 1998.

Jerome A. Clifford, *The Independence of the Federal Reserve System*, Philadelphia, University of Pennsylvania Press, 1965.

The Federal Reserve System-Purpose and Functions, Board of Governors, Washington D.C., Federal Reserve System,. 1994.

Annual Report : Budget Review, Board of Governors, Washington, D.C., Federal Reserve System, 1998.

A Day at the Fed, New York, The Federal Reserve Bank of New York, 1998.

William Greider, *Secrets of the Temple : How the Federal Reserve Runs the Country*, New York, Simon & Schuster, 1987

Roger T.Johnson, *Historical Beginnings...the Federal Reserve*, Boston, Federal Reserve Bank of Boston, Mass., 1995.

Axel Krause, *Inside the New Europe,* New York, HarperCollins, 1991; (*La Renaissance: Voyage a L'Intérieur de l'Europe*, Paris, Seuil, 1992).

William Randall, *Thomas Jefferson-A Life*, New York, Harper Collins Perennial, 1994.

Bob Woodward, *The Agenda : Inside the Clinton White House*, New York, Simon & Schuster, 1994.

PERSONALITIES INTERVIEWED

Ephraimson Abt-, Hans, consultant, Ridgewood, N.J.

Robert Auerbach, professor, Lyndon B. Johnson School of Public Affairs, the University of Texas at Austin, Tex.

Peter Bakstansky, senior vice president, Federal Reserve Bank of New York

Stephen Beckner, senior reporter, Market News Service, Mebane, N.C.

John Berry, senior reporter, The Washington Post, Washington, D.C.

Alan Blinder, professor, Princeton University, Princeton, N.J.

Irv Chapman, senior reporter, Bloomberg News, Washington, D.C.

Lynn Fox, Director, Public Affairs, Federal Reserve Board, Washington, D.C.

Barney Frank, Congressman (D-Mass.) Washington, D.C.

Lyle Gramley, consulting economist, Mortgage Bankers Association, Washington, D.C.

Alberto Hasson, Head of Division, Human Resources and Administration, European Commission, Brussels

Elizabeth Johnston, senior evaluator, GAO, Washington, D.C.

David Jones, vice chairman, Aubrey G. Lanston & Co., New York

Edward Kelley, governor, Federal Reserve Board, Washington, D.C.

Donald Kohn, director, monetary affairs, Federal Reserve Board, Washington, D.C.

Peter Kovar, chief of staff, Congressman Barney Frank, Washington, D.C.

Roger Kubarych, managing member and chief investment officer, Kaufman & Kubarych Advisors, New York

John Lopez, senior counsel, subcommittee on domestic an international monetary policy, Committee on Banking and Financial Services, House of Representatives, Washington, D.C.

James McLaughlin, director, regulatory and trust affairs, American Bankers Association, Washington, D.C.

Hugo Paemen, Head of Delegation, European Commission, Washington, D.C.

Leon Panetta, professor, Santa Clara University, California

Guy Pontet, directeur du cabinet, Governor of the Bank of France, Paris

P.D Rodger., secretary, Bank of England, London

Felix Rohatyn, U.S. ambassador to France, Paris

Donald Winn, assistant to the Board, Federal Reserve, Washington, D.C.

Janet Yellen, chair, Council of Economic Advisors, Washington, D.C.