

## Chapter Four

### The Monetary constitution

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#### **Introduction**

An part of the small c constitution, a superstatute, is a political achievement. For a new statutory regime to embody the requisite stability to become “super” it must have or build a basis of political support that is both broad enough and durable enough to survive wars and depressions as well as the shifting winds of party control. Secondly, the values it serves must also be central or fundamental to the lives that most Americans envision for themselves and their fellow citizens. This too is a kind of political achievement but it is not so much about building a coalition of support than of constructing or maintaining a kind of widely shared or imagined vision of civic life. We think that this second necessary condition may well support the first. That nearly everyone thinks that speech rights are important an important part of our public lives surely contributes to the support of such rights, at least at the abstract level.<sup>1</sup>

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<sup>1</sup>There is, of course, abundant research showing that abstract support for speech rights doesn't translate perfectly into support for speech rights of unpopular minorities.

But such connection is not inevitable. People may not be aware of how important some value or liberty is to their well being or those of their fellows, or they may be unaware of how that value or liberty may be promoted or threatened. We imagine that health care may currently be an issue where, though people are generally aware of its central importance to their lives, they disagree as to how access to it might be most effectively guaranteed. And, even if there is awareness of both of these considerations, one expects that collective action problems may interfere with the creation of either Constitutional or superstatutory (small c constitutional) protections. Besides, even if a statute is created that has the potential to be a part of the small c constitution, there is no guarantee that it will receive the broad and durable support necessary for it to attain super status.

The subject of the last chapter exhibited, over a relatively short arc of time, a growing public awareness of the many institutional impediments to voting that had been placed in the way of disadvantaged minorities, together with a recognition as to how those obstacles might be removed. The easy thing to do was to abolish the particular practices that prevented minorities from voting that were in place at the time. Public support for that abolition was strong and has remained so as far as one can see. More difficult is the task of guaranteeing that new impediments, however subtly disguised, would be removed as they appeared. Doing this involves conferring power on some public agency to take actions in advance of any specific threat and this is more difficult to get people to agree to. As can be seen in the periodic struggle over preclearance, this aspect of the VRA may not yet have become part of the small c constitution. It is hard to say.

The development of a statutory regime supporting a central bank, charged with the mission of maintaining the value of the currency, is an example of the difficulties of empowering

such an institution. A central bank, in its nature, must take unpopular actions. It must sometimes limit the capacity of enthusiastic investors to get funds and at other times take actions that will put people out of business or even out of their homes. The power to take such actions is not only dangerous, it is valuable to politicians who might want to interfere with the actions of a bank for their own interests. For that reason, it is widely believed that central banks ought to be “guaranteed” a degree of independence from the government of the day. But this is attractive only if thought that the bank can be trusted to do the right thing. Doing the right thing, in turn, depends on the bank leadership having some, generally valid, idea of what that thing is, as well as having the determination to do it even if it is painful. It is a delicate matter. And it is a mark of how important such an institution is, and is thought to be, to the well being of the nation that, from the very beginning, Americans have permitted the development of such an institution (whether or not it was called a bank) and, increasingly agreed to provide it with institutional protections.

The history of central banking is complicated by the fact that monetary historians typically describe earlier bankers as having false beliefs about the effects of their actions and therefore as choosing policies which are either mistaken or unachievable in some way or other. The result is that the history of central banking is often told as a story about bankers, or their political supervisors, coming progressively to grasp a better definition of the money supply, or to a better understanding of the way in which various actions by the bank might affect the economy. This kind of history is often derided by historians of other subjects as whiggish, or

normatively guided, in the sense that it is a story of the veils of ignorance successively falling away until the enlightened present is reached.<sup>2</sup>

Our interest, by contrast, is in describing the development of institutions over time, which we take to be a positive or descriptive question rather than a normative one. But we are not sure that this distinction can not actually be maintained. Part of the explanation for why some institutional change or other occurred is that previous policies led to some politically unacceptable result because they were based on bad theories. Historians of banking often point to the falsity of the some doctrine as an explaining why it could not be sustained – at least not over a long run. It seems a short step to argue that an institution that encouraged people to act on false beliefs would not stable either. A good example might be found in the reforms of the Federal Reserve System embodied in the 1935 Banking Act, which followed the disastrous monetary policies of the early 1930.

We agree that bad outcomes can cause institutional shifts, but we think that what is unacceptable or bad is not merely a result of facts about the effects of policies. It mattered, for example, that the Democrats had achieved immense and repeated congressional majorities and they had embraced political responsibility for the economy. Had those victories not occurred, bad economic results might not have resulted in changing the structure of the Federal Reserve System. At least not changes of the kind that occurred (which centralized the structure of the System in a way that made it more open to influence emanating from the political branches). So,

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<sup>2</sup> Whiggish narratives are naturally tempting for historians of science, where a sense of progress seems fairly natural, and perhaps it is as natural for historians of economic policy as well, at least insofar as economic policy is partly informed by economic science.

while we shall try as best we can to avoid the normative issues that fascinate monetary historians, we will not always succeed in maintaining this separation.

## **1. Central Banking**

From the first days of the Republic no issue has been more difficult and politically fraught for the new national government than the establishment and maintenance of a national bank. Think of it. The first political parties arose mostly to support oppose Alexander Hamilton's economic program, the centerpiece of which was the proposal to charter the First Bank of the United States. Forty years later, the Whig party formed in large part in opposition to Jackson's crusade against the Second Bank and was sustained by it throughout the 1830s. When the Whigs finally won the presidency for the first time in 1840 it was arguably the result of the consequences of the anti-bank economic program of Jackson's successor. The succession of partisan crises following the end of Reconstruction is also greatly attributable to issues of monetary policy – principally the fights over resumption, greenbacks and silver. And, if economics historians are right that misguided monetary policies are what made the Great Depression great, we can trace the rise of midcentury Democratic dominance substantially to failures of central banking. Finally, who can doubt the crucial role of bad money policy in the collapse of the Carter administration and the subsequent dominance of Republican governments to the present (with minor hiccups)?

For a long time a part of the issue was Constitutional (big C), as it was not at all clear either from the Constitutional text or from the memories of its framers that the federal government had the power to charter such a bank, or that paper money money could be issued under federal authority. Indeed the creation of the First Bank was the occasion of the initial

division between those, like Madison and Jefferson, who were inclined to read the terms of the Constitution narrowly and those, following Alexander Hamilton, who favored a more expansive reading. It rapidly became clear, however, that this interpretive issue was not really at the core of the conflict over the bank, especially after the First Bank expired and, after its twenty year term and the Second Bank was agreed to. This is not to deny the importance of that interpretive issue and its continuing vitality to the present day. But it is to emphasize that the powers and conduct of a federally chartered bank, and the expectations and fears about how the bank would or could act, became increasingly central to its politics.

The deeper issue was political: the politics of banking policy in every period became issues of party politics. And this was so because the issues involved activated deep seated and resilient conflicts of interest within the electorate and, perhaps as importantly, conflicting visions as to what the United States was and ought to become. The gross outlines of these cleavages are clear to anyone with a passing knowledge of American history: regional divisions either between the industrial and financial centers and the hinterlands, or between the North and South or East and West, localized class conflicts of various kinds, divisions between creditors and debtors, as well as emergent conflicts within the banking class itself (many of which were themselves products of banking legislation and policy). The constitutional issues, the issues of principle, played out unstably over this base of conflicting issues but were not (we think) fundamental causes of them.

Our argument in this chapter is that a federally chartered and relatively independent central bank emerged eventually as a superstatute, a part of the small c constitution. But the path to an independent central bank was anything but linear and took years of struggle. For one thing central banking functions were exercised by different institutions: sometimes banks, sometimes

the Treasury Department, and sometimes being left to market-like institutions. Importantly the role of the central banking institution over time, shifting between acting as a traditional banker to a special customer, to behaving like a large, but still traditional, bank with some important privileges relative to its competitors, to a bank to other banks, to a regulator of the financial and banking systems, being what would now be understood as a central bank. And its degree of independence varied greatly overtime as functions were exercised by a publically chartered private institution, to a department of the federal government, to decentralized markets, and back again.

As the bank, or the succession of bank-like entities, evolved its support coalition shifted and, eventually, broadened. That broadening was crucial insofar as it created enough political space for the bank to take unpopular actions such as restricting credit, without suffering a withdrawal of its authority. Though, in some ways that support coalition of support remains fragile, especially in extreme circumstances of war, depression and monetary crisis. Moreover, the domestic aspects of operation of the bank have always been vulnerable to international pressures of various kinds. And always, there is a tension between the short run desires of however controls the current government, their medium term electoral interests, and longer term interests of the government and of the people more generally. These conflicts are what made the struggle over the institutionalization of a bank so difficult and what keeps it from being definitively settled, once and for all.

Why the support for an independent central bank broadened is a hard question. We think it is partly attributable to the explicit policy of its leaders to narrow of its focus to inflation regulation and cushioning domestic banking institutions from shocks, at least temporarily. But there is no consensus, even now, on a narrow role for the central bank and so it is impossible to

be very confident about this judgment. We also believe that part of its broad support is due to something more diffuse: to a kind of “agreement” on the kind of country that the US is and ought to be: an entrepreneurial and commercially driven country with a great appetite for easy access to capital for good ideas or living good lives and it seems a matter of general agreement that these aims can best be pursued in a noninflationary economy.

As far as we can see, the need for central banking functions, maintaining stable price levels and preventing panics, was acknowledged early in the history of the Republic. But there was persistent disagreement as to what kind of institutions ought to do the job. Probably by the time of the Bank Wars of the Jackson administration, which are sometimes understood as a rejection of a powerful central bank, the nation had largely accepted that somehow central banking functions would have to be exercised and that the economy would suffer and elected officials would be punished politically if they were poorly executed. Probably most people thought that price levels would automatically stabilize under the gold standard but already there had been occasions to see that didn’t always work. But if that belief was warranted, people could see that the adjustments frequently brought on booms and busts and financial panics which did a lot of damage. Even the Jacksonians saw the need for some kind of coordinating institutions operating under some degree of governmental control.

But, while the exercise of central banking functions was more or less accepted from the early days, it was not clear how independent it ought to be from federal control. As soon as it became clear that the Second Bank would not be renewed, its federal deposits stripped away, and its remaining lame duck powers curtailed, those powers did not cease but simply migrated to other public and private institutions, which continued to use them albeit in somewhat different ways. Arguably, there were failures of coordination that ensued and they may have resulted in

various financial panics. In any case, the decentralized system did not survive the onset of civil war and the explosive economic transformations of remainder of the “long” Nineteenth Century.

Eventually, a complex superstatutory central banking regime emerged. It is partly embodied in the 1913 Federal Reserve Act but was very substantially amended later on, especially by the 1935 Banking Act, but it also includes numerous other federal statutes that affect the powers, institutional structure, and operation of the Federal Reserve system. To a greater extent than some of the other superstatutes we discuss in this book, the emergent central banking statutory regime is complex, in that parts of some of the relevant statutes have effectively been “read out” of the superstatutory regime such as, for example, the Humphrey-Hawkins Act and various other statutory directives that aimed at broadening the mission of the Federal Reserve System.

And the story is complicated by the possibility that the system in place now – a relatively independent bank which accepts a relatively focused definition of its responsibilities and mission – may not survive some future crisis. After all, the underlying pattern of interests has not really changed very much: the current government always wants to borrow at favorable rates and also wants to maintain prosperity, at least as elections approach. And, ordinary people want to be able to plan their lives, to save and invest in their businesses and houses and retirement, under conditions of reasonable financial stability. As long as external shocks to the financial system are not too great, or are adequately managed to permit these interests to be satisfied, it is likely that the institutional system will be preserved. But there no guarantees.

## **2. The History in a Nutshell**

The story is simple in one way: the First Bank was created in a sharply contested fight that pitted Alexander Hamilton's broad reading of the Constitution against the strict constructionist views of the Virginians, James Madison and Edmund Randolph. The bank was to be a private institution in which the government would hold some stock and to serve as both a depository of some government receipts as well as a lender to the government. Its capital would consist partly of gold and partly of government debt. While it could maintain branches wherever it wished and issue notes, there was no explicit awareness of its capacity to regulate the supply of money (a core central banking notion). Part of the reason is that, under a specie standard, such regulation was thought to be automatically achieved by movements of gold and silver. Still, that is what it did: it accumulated state bank notes and could demand payment in specie if it thought credit was too loose. As far as is known, the bank used these regulatory powers cautiously and did not much exploit its competitive advantages relatively to state banks and in any case there were not so many state banks around at the start. But the state banks proliferated.

While the First Bank was widely accepted by commercial and banking and banking interests, and it even turned out to be fairly popular among its earlier opponents in the South and West, its charter was not renewed when it expired. The nation money supply relied mostly on the operation of the traditional gold standard under which banks (both state and national) were required to convert currency into gold and the federal bank generally maintained a conservative (high) ratio of specie to notes and was able, and usually willing, to finance species shortfalls in the states thereby limiting financial crises.

But under the pressure of war finance – the need to expand government debt and the inflation that followed from it – President Madison agreed to the creation of the Second Bank which, much more than the First, acted in ways that brought it into conflict with emerging state

banks, especially in the northeast. During the war, banks extended credit widely resulting in a general price rise and, in the South and West, were forced to suspend convertibility into gold. The result was a gold drain toward places where gold was more valuable: to the New England banks which maintained convertibility throughout the war or out of the country. Under a specie standard as the gold reserves disappeared, banks are forced to withdraw credit. So the first job of the Bank was to bail out Southern and Western banks which it busily tried to do by making credit available to them. At the same time, it was to help Treasury to reign in the postwar inflation by restoring gold convertibility at pre-war rates, essentially by retiring government debt, which contradicted the first task. The resulting deflation, which was really the result of Treasury policy of buying and retiring government notes, and the ensuing depression in 1819 did nothing for its popularity anywhere. It is clear enough that it was Treasury and not the Bank that was doing the dirty work of conducting monetary policy; indeed the Bank actually tried to offset Treasury policy by extending credit to banks even while Treasury was buying up debt with the aim of shrinking the credit in the system. But the Bank was widely blamed for the resulting depression in any case.

New conflicts with state banks surfaced too, and soon ended up in the Supreme Court where the Constitution was read broadly enough to accommodate the bank statute, and the states were forbidden from interfering with its operations (viz *McCulloch* and *Osborne*). Moreover, under its second president, Nicholas Biddle, the Bank began for the first time explicitly to embrace central banking functions, regulating the currency in a countercyclical manner by

influencing the conduct of other (ie. State) banks and serving (sometimes) as a lender of last resort.<sup>3</sup>

These developments brought new troubles both Constitutionally and politically. Constitutionally the problem was again one of broad versus narrow construction. The Democrats were traditionally inclined to narrowly construing the Constitution's terms and could not accept that the government could draw the power to regulate paper currencies (banknotes) from its coinage power. Yet this was precisely what the second bank was doing in order to provide for a uniform national currency and to stabilize its value. Politically the problem was that the national bank was not only effectively regulating state banks, it was also directly competing with them by issuing its own loans at favorable rates. Moreover, state banks had increased greatly in both number and political strength. Add to this, the rise of Andrew Jackson, a man who had a chronic distrust of banks, all banks, and strong preference that any regulatory functions served by The Bank, ought to be exercised by the government directly.<sup>4</sup> In any case,

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<sup>3</sup> The policies of the Second Bank made clear the tensions between the (fiduciary) duties of the bank to its stockholders and its public mission. It received a substantial public subsidy every year in exchange for serving as a lender and depository for the federal government.. And as a private institution its interests sometimes ran counter to the public interest in preventing panics or maintaining a stable currency. Moreover, as Nicholas Biddle and other central bankers learned early on, performing a public duty, such as restricting credit to discourage speculation, is no guarantee of political popularity.

<sup>4</sup> We confess that the basis on Jackson's animosity remains a bit mysterious. He seems to have had four objections to the Bank: a constitutional doubt that the chartering a bank was within Congress's powers. And as the national debt was nearly retired, he probably doubted that there was any constitutional "necessity" for it at all as there may have been in Hamilton's time or during the 1812 War. He also had a democratic objection: he recognized (indeed, Biddle did not let anyone forget) that the bank exercised great powers with public funds and he probably thought that such powers ought to be controlled by elected or appointed officials. If it was not, it could only be a source of corruption and intrigue. Third, he believed that "hard money" which he opposed to a monetary regime that produced booms and busts, was favorable to agricultural interests which played a large part in his support. Finally, he blamed the Bank for abusive

the Second Bank expired after a sharp conflict over rechartering and, until 1913 there was no national bank at all.

This is not to say that central banking activity disappeared. Indeed not. As it had following the War of 1812, the Treasury Department assumed many of the “central banking” functions that had been performed by the Second Bank, by creating a system of “pet” (state banks) to hold federal deposits and to intervene actively in monetary decisions through them and separately.<sup>5</sup> Politically, in this sense, the Jacksonians got their way, at least in part. But a system of clearing house associations also emerged over time that permitted some of the features of a national currency to be pieced together under the auspices of state banks. It seems fair to say that the state banks became far more independent and collectively more powerful in influencing monetary phenomena even if they could not always coordinate to exercise that power in ways that served their collective aims. While the period was one of booms and busts and sometimes unstable banking practices, the clearinghouses and the Treasury generally managed to maintain a specie based currency with only occasional breakdowns..

The pressures of war finance, however, produced changes that modified the emerging system: gold convertibility was suspended and a new currency, greenbacks, was issued in great quantities; a series of banking acts during and after the Civil War permitted federal chartering of banks and then placed a punitive tax on notes issued by state banks, effectively putting them out

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behavior, as did many of his contemporaries, especially for bringing on the 1819 depression. That this indictment was probably ill-founded was no obstacle to bringing it. While these factors are numerous, they seem inadequate to account for the persistence of his antibank efforts and of the place he gave to it in his program.

<sup>5</sup>The Whigs extended Treasury’s role in embracing “Independent Treasury” legislation. Their attempts to restore something like the Second Bank foundered on Tyler’s vetos.

of the business of currency creation. Greenbacks were especially interesting for us since they amounted to the explicit creation of a permanent paper currency, that were considered legal tender for everything and not only for debts to the government, of a kind that virtually everyone admitted at the time would have been unconstitutional in peacetime.

After the war ended the constitutional issue divided the lower courts along partisan lines, with Democratic judges nearly unanimously adhering to the traditional view that greenbacks were unconstitutional. And, in its initial judgment on the subject, the Supreme Court initially agreed, ruling that the legal tender provision was unconstitutional (in *Hepburn v Griswold*, 1870). But then almost immediately, under government pressure (and with two new, pro-legal tender justices added to the court), reversed itself (in *Knox v Lee* and *Parker v Davis*, both in 1871; see also the reaffirmance in *Julliard v Greenman*, 1884), pretty much conceding the constitutional ground to the government. The leading arguments were essentially ones of expedience (people had made contractual commitments under the greenback system and the Court ought not to undercut these arrangements) and preconstitutional (that the capacity of a government to issue currency was an essential “incident” of sovereignty which the Constitution itself was powerless to remove).

This is not to say that the Republicans had any principled brief for greenbacks. In fact from the end of the war, there were strong, federally led, (Republican) efforts to place the currency back onto either a gold or bimetallic standard as a way of stabilizing its value both domestically and internationally. But, the attempts to eliminate or “redeem” greenbacks after the war were half-hearted and generally unsuccessful. Efforts to stabilize money on a specie standard were fraught with problems politically as any such action would entailed a forced deflation if done rapidly. So Congress basically kept deferring resumption effectively allowing

the economic expansion to catch up the money supply, and this fineally achieved a gradual resumption in 1879. But while greenbacks could now be converted, they were not removed from circulation. No-one wanted to impose the pain of withdrawing the vast quantities of greenbacks they remained a permanent part of the money supply.

After resumption, however, unless the supply of gold were somehow (magically) to increase at the rate of economic expansion, limitations in the gold supply would tend to produce price deflation at a rate that would be hard to anticipate and therefore painful. Partly as a response, and also in response to the political influence of silver state congressmen, in the same year that resumption was accomplished (1879) Congress authorized the injection of silver into the currency base which, under Treasury leadership, moderated the likely deflationary effects of the resumption policy.

While Treasury, by managing the silver policy among other things, exercised some of the central banking functions, and while the clearinghouses could cushion the effect of shocks on the growing and dispersed banking system, the post war system had no definite lender of last resort that would provide any real shelter from the blow of external events. This meant that state banks remained vulnerable to runs and failures. Such events had to be prevented by requiring banks to maintain their own reserves there were legislative efforts to do this. And the banks themselves found ways to build some capacity for coordination, such as creating clearinghouse associations, that could inject credit as part of their operations. These actions did not prevent a series of wrenching economic collapses, the most notable taking place in 1893 (triggering the collapse of support for the second Cleveland Administration and a resulting Republican ascendancy that lasted, with only a brief interruption til 1930) and 1907 (during which J.P. Morgan intervned with his own wealth to prevent a broader collapse).

It seems clear that there was an emerging consensus that a federally chartered institution was needed that would perform central bank functions – specifically providing an “elastic” currency that could be used to deal with banking crises of the kind that had lately appeared – and this required coordinating the activities other banks.<sup>6</sup> Such an institution, if it was workable, would be able to respond more actively to international or domestic shocks, though economists nowadays think it had a poor basis for identifying the conditions that should trigger action and what action it should take. By this time, it seems that most of the Constitutional issues had already been resolved in a way that would make room for such a new and powerful creature (a remarkable development in itself). Indeed, the creation of the new system was seen as resolving some chronic constitutional problems of the pre-1913 banking world, specifically the operation of the clearinghouse associations which entailed creating currency in times of crisis. By 1910 the Republicans, led by Senator Nelson Aldrich were already far along in their plans for a new institution, but the intervening elections of 1910 and 1912 shifted the responsibility for action to the Democrats. Their efforts were crystallized by Virginia Representative Carter Glass in the Federal Reserve Act of 1913.

While it is possible to look back from the present vantage and see in that Act the banking superstatute that we are trying to describe, that would be too simple. Glass, was a conservative Democrat from Virginia and he helped establish a Federal reserve system that was intended to be a significant but short step from previous practices. It would provide a legal and (now) Constitutional basis for issuing a new currency (Federal Reserve notes) but remain a decentralized system: the core elements of which were private banks organized into Federal

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<sup>6</sup> Economists nowadays are divided on whether this consensus was really warranted. See Timberlake for an opposing view.

Reserve districts which was led by a Federal Reserve bank, but the key policy making body was to sit in Washington where it could take account of governmental views.

The Federal Reserve System was remarkable in many ways, not least in placing enormously important public functions with private bankers and, essentially, removing them from direct Treasury influence (which would presumably be diluted within the Board). The policy body (the Federal Reserve Board) was to direct actions that would be carried out by the reserve banks, in ways that were responsive to local conditions. But that hope was compromised from the beginning, partly by placing the Federal Reserve Board in Washington, a pretty sleepy town at the time and that was quite removed from financial centers. Board recommendations to the reserve banks could be tardy or irrelevant to shifting market conditions and, of course, subject to governmental intervention. At the same time the act reserved a great amount of authority to the presidents of the reserve banks who were expected to tailor their actions to local conditions. In effect, and in the views of those who drafted the statute, the action arm of the Federal Reserve system was the member banks rather than the Board. In many ways, this was not so much of a departure from the earlier clearinghouse model.

This situation led to a kind of regular conflict between what the government wanted (cheap loans were high on the list as was a desire that banks not fail) and what the regional banks wanted, especially the powerful New York Bank (which was partly to maintain a stable gold based currency that could meet international and local obligations). In effect, if not in intention, the New York bank had effectively assumed many of the central banking functions until the time of the 1929 stock market collapse.

Glass's compromise proved unstable: under pressure of post war inflations, and depressions, the effective power to set monetary policy flowed to the New York banks (which is

where it had been exercised under the earlier clearinghouse system for the most part) and so the Fed was a kind of bipolar structure with two centers, one of which was pretty irrelevant. This system seemed to work pretty well for a while. The onset of the first World War disrupted the operation of the gold standard, as our trading partners departed from it, and there was massive shift of gold toward the US in exchange for capital goods while the US was a noncombattant, and subsequent reversal in flow afterwards. While no new greenbacks were issued, the Fed obligingly issued note in response to Treasury demands in issuing bonds and in guiding a monetary policy that facilitated the war effort. The postwar inflation eventually induced an increase in discount rates but not until after a long period of temporizing in order to help the Treasury service its outstanding debt.

The Federal reserve ‘discovered’ open market operations in the early 1920s (it created a committee of reserve bank officials to conduct them) and employed those to buy and sell securities. The purpose of such operations was broadly the same as its traditional discounting activities: to influence credit availability and therefore currency value. But it represented a powerful new tool that could operate on a much larger scale and that could greatly enhance the capacity of the new system to smooth out disruptions.<sup>7</sup> Anyway, the system worked pretty well until clear headed Benjamin Strong the leader of the New York reserve bank, and defacto leader of the whole system, died in 1928, followed by the systemic financial collapse of 1929. In the following few years, monetary policy fluctuated ineffectually, but was generally disasterously contractionary in its direction, as various Fed leaders, operating under conflicting economic

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<sup>7</sup>Economists and the time, and even now, dispute whether this tool was used in a way that had that desirable effect.

theories, struggled for authority and no-one replaced the leadership that had been lost in New York.

During that period, the federal reserve (and the New York Bank) managed the money supply by continuing to operate under the norms of the gold standard, but it had become increasingly evident that there were enormous international pressures in that system that interfered with its capacity to respond to domestic fluctuations. The result was a general deflation that ultimately turned into a monetary collapse. This kind of thing had happened before of course, most recently in the early 1920s, but economic activity picked up after a year or so in all of the earlier events. While there is much dispute on this, most monetary historians believe that the actions of the Bank, which tended to be contractionary even in the face of successive waves of bank failures, probably prolonged and deepened the Depression even if it they did not actually bring it about.

In any case, the onset of Depression, and especially its unprecedented length and depth, changed the political environment in important ways, both domestically and internationally. Most of our major trading partners were forced off the gold standard and, unlike earlier suspensions (of convertibility) this time the shift seemed permanent. At best any resumption would have to follow extensive revaluations. Domestically, the Roosevelt administration's immense popular support and the unbroken string of increasing Democratic congressional majorities from 1930 through 1936, facilitated a number of institutional changes that would not have been dreamt of earlier. First the president "nationalized" the gold stock at the current price (a bit more than \$20) and immediately revalued it to \$35, achieving an massive windfall for the government. For another thing, part of the "lender of last resort" function that had previously

rested with the reserve banks, was placed in the FDIC and in that way separated from other central banking functions that remained with the Bank.

Most importantly, the structure of Federal Reserve System itself was reformed (in the 1935 Banking Act) in ways that increased its centralization (placing more powers with the Board rather than leaving them to the regional banks and effectively moving its action arm, the Open Market operation, to Washington), and giving it powers to set the reserve requirements for loans. The purpose of the centralizing moves was to prevent the uncoordinated policy drift that occurred after 1929. But it also permitted much more governmental influence in monetary decisions than had been possible under the previous system.

Turning now to the legal terrain, by early in the Depression, the Constitutional landscape had shifted importantly. This can best be seen in the response of the Supreme Court in the Gold Clauses cases, which invalidated contractual terms that required payment in gold. Chief Justice Hughes in ruling for the government read the coinage clause of Article I, Section 8 very broadly to include the power to eliminate contractual terms that interfere with the regulation of the currency – explicitly including paper currency whether or not it is backed by gold.

Later on, the 1946 Employment Act Congress attempted to articulate some of the Fed's "duties," and effectively to add new ones. This is not to say that these new obligations were uncontroversial simply because they were agreed to in Congress. Was the bank to stabilize prices or to smooth interest rate fluctuations? Or was it to maintain high employment or growth? It rapidly became clear that these goals could conflict and that there little guidance when they did. Even if some of these new goals were agreed to by Fed leaders, there was enormous disagreement over what policies might advance them. And there still is. In any case, the majority behind the legislation was small and temporary, and an era of divided government had just

begun. So, despite the attempts of political leaders to bend the Fed to political purposes, perhaps there was some breathing space for a central bank to operate independently. But the Fed did not seem to take up that opportunity until early in the 1950s. Instead, it continued to accommodate government policies – especially financing the Korean War – by letting the money stock grow on demand. It was not until the 1950s that the Federal Reserve was able to establish, for a decade or so, a policy of moderate monetary expansion and stable price levels.

This broke down in the mid sixties and, as always, wartime finance had a great deal to do with it: the government was reluctant to raise taxes to run the war preferred to run deficits instead. Successive Fed leaders pursued accommodative policies, permitting a vast expansion in public debt, with eventual inflationary consequences. Subsequently, in the newly Democratic congresses of the mid-1970s there was a renewed push for the Fed to broaden its policy goals to include a range of objectives, though, given the hostility of the Administration to such a course, it is doubtful that the legislation as such had any direct effect. Still, Fed leaders certainly paid lip service, and more, to nonmonetary objectives even if while they tended to admit little capacity to pursue them.

In any case it was not surprising that the price level increased dramatically from the late sixties until after the 1980 election when it became clear to then Chairman Volcker that he actually had a window to clamp down on endemic inflation by sharply restricting money growth. While Fed policy in the Volcker era remained somewhat uneven, the eventual accession of Alan Greenspan to Fed leadership began an era in which the Fed maintained a pretty single minded monetarist policy and price level increases moderated. In effect the broad set of goals articulated in the 1946 Employment act were renounced. Until the Iraq War, monetarist policies have not really been tested. But the reluctance of the government to finance the war by taxes places some

pressures on Fed policy and time will tell how it responds. Moreover, should Democrats take the White House in 2008, their traditional embrace of a wider set of goals for the monetary authority will press the Fed to relent on its single minded commitment to restraining inflation.

#### **4. The Constitutional Perspective**

The Constitution has never offered much resistance to the political demand for central banking activity. The First and Second banks were created despite severe Constitutional objections that Congress lacked the requisite authority; indeed one of the leading opponents of the first Bank agreed as President to authorize the chartering of the Second Bank. When the new institution was tested in the Supreme Court, the Constitution was interpreted servilely to permit them.

The opposition to the Second Bank, while ostensibly grounded in the Constitution, really amounted to a demand that its central banking functions be shifted to the political branches rather than being exercised independently. On that view one would think there was a very strong argument to be made. Nicholas Biddle's bank enjoyed a privileged position from the federal government, especially from its functioning as creditor and debtor to the government, and as a result had the capacity to influence the price level, but it remained a privately held commercial bank operating in competition with other banks. That it was a commercial bank preserved for it a great degree of independence from the federal government. But it also meant that it could use the powers "delegated" to it in ways there could not be effectively supervised. However, this argument rests on the idea that it was possible to avoid effectively delegating public authority to private banks by placing governmental funds in banks and borrowing from them. In the context of the Jacksonian political economy, this was probably impossible. In fact, while the

Jacksonians succeeded in destroying the Bank itself, they did not really succeed in moving monetary policy into the control of elected leaders – rather, central banking activity effectively migrated to New York banks where it remained for nearly a century.

The Constitution itself offered no resistance for governmental demands for paper money. Banks began creating paper currency from their earliest days, and the government played a role in regulating those issues in one way or another. Sometimes it managed this by acting through a separate national bank, if there was one, but if none was in existence, through the Treasury department, which then employed the growing network of commercial banks. Moreover, when the political branches intervened in monetary regulation it was often to cushion the political impact from actions taken by the monetary authorities of the time, which sometimes acted either to encourage speculative binges or to rein in inflationary tendencies. A record of such interventions can be seen in political and judicial attempts to deal with greenbacks following the Civil War. The Constitution itself was thought to be quite inhospitable to the creation of a paper currency, at least in peacetime, but it was politically impossible to eliminate them. The Court valiantly made the attempt but was soon forced to reverse itself. Later on, during the Great Depression, as the political branches asserted more direct control over the monetary standard, they sometimes took even more dramatic actions. During the 1930s, for example, Congress not only imposed an immense forced loan on gold holders, requiring them to sell their holdings to the government at a low price, and it also summarily invalidated contractual terms requiring payment in gold. Again the Constitution was read in a way as to permit these massive property transfers.

##### **5. The Monetary constitution (small c)**

In 1787 everyone thought that the regulation of the money supply would be managed automatically under the gold standard. Perhaps a private bank, like the Bank of England, would emerge to carry out some useful governmental functions, but no one thought that there was a need for a policy making body to actively regulate the price level. That could be left to the market. Indeed, the English were pretty foggy on the need for active policy too, and the early history of their Bank's actions in this regard reads like a catalogue of error. Until the writings of Henry Thornton, David Ricardo and, later on, Walter Bagehot, there was little public understanding of how a monetary authority should behave. And, for a long time after that, that understanding rarely penetrated the Bank itself. No surprise then the Americans stumbled by chance on the need to active currency regulation even under the gold standard.

But, following the War of 1812, the perils of leaving monetary regulation to the market began to become clear. It is not that the market didn't work: it was that market adjustments could be politically unbearable. So a sense emerged, mostly in practice rather than theory, that a monetary authority could cushion readjustments, even if it could not prevent them. But even if a monetary authority could be useful, there was no guarantee that it would be. The Second Bank was a commercial bank and it was not obvious that its leaders could be counted on to pursue the public interest over their own or that of their stockholders. This suspicion certainly played a large part on why that bank was dismantled. So, the constitution of a monetary authority is a delicate matter. It needs to be protected from political interference in the normal course of its operations, but it also needs to pursue the public purposes given to it legislatively.

Any institution or set of practices that sets or influences money supply is vulnerable to political interference. This is so even if the operation of the monetary institution is widely thought to be beneficial as might be the case when it helps maintain a stable currency. Generally

speaking, the conditions for political interference correspond to periods in which the political class is unified in pursuing some goal that conflicts with the maintenance of a stable currency. These conditions can be met by war, economic disruptions such as depressions or sustained inflations, or unifying or “critical” elections that produce large cohesive political majorities. In the historical narrative in the previous section, wars lead government to want to borrow and depressions can have the same effect. And it can be painful to wring inflationary expectations out of the financial system and governments are never enthusiastic about enduring that pain. The cases are more diverse when it comes to the effects of large political majorities that arise electorally. Some of these can be in response to hard times, or a failed war effort of course, and will produce predictable pressures on the Fed to accommodate politically popular policies. But majorities can also push for changing Fed objectives as Democrats did in the 1946 employment act and later in Humphrey-Hawkins legislation.

When circumstances arise favoring political intervention in monetary policy, political leaders demand that the Fed facilitate the pursuit of some political goal – such as winning the war or some other set of projects – and subordinate its own goals to that end. It can do this in various ways: by commandeering the monetary institution (such as suspending convertibility under the gold standard), destroying it (as Jackson did with the Second US Bank), or imposing new politically controlled institutions (as with the Independent Treasury from the 1840s). Failing to accommodate a powerful and unified majority is a dangerous course of action for the Fed. But it is also dangerous to take policies that are identified with one of the parties or with an incumbent administration. This is political dilemma of the Fed. Even as it may wish to take actions consistent with a narrow view of its capabilities – restraining prices – it needs to pursue a more proximate goal of maintaining enough political support so that political authorities will not

intervene. Usually the best policy is to try to divide political forces. But sometimes (in wars and other extreme events) no such policy is possible.

Political leaders, like the rest of us, generally benefit from having a stable currency and have reason to establish and protect a set of institutions and practices that permit its achievement, even in circumstances where they face strong temptations to intervene. But they also recognize that there are special occasions where stable money ought not to be the overriding goal. That is why wars are so troubling for monetary policy. In this sense the political class, and the electorate more generally, internalizes the problem of creating monetary authority that is sufficiently independent to achieve a stable currency, without being so independent as to frustrate the pursuit of other ends that the majority. At least not if those other ends are sufficiently valuable.