1971 and the Undermining *of* Fed Independence

By Roger Lowenstein

Today the U.S. central bank's sense of a shared mission with the administration has been internalized.

Postwar, there were two revolutions in American central banking.

The second occurred in 1971. On a Sunday night in August when most Americans were returning from beaches and preparing to watch *Bonanza,* President Richard Nixon stunned the country by delinking the American dollar from gold.

Nixon closed the gold window because America had issued too much paper for its available bullion. Once the window was shut, America discovered what inflation really looked like. Over the next decade, the dollar lost more than half of its purchasing power.

Bonanza is not coming back, but it is fashionable to think that another Nixon shock, that is, monetary upheaval, is a-comin'. Maybe, but people looking for an historical mirror should be familiar with the first revolution, twenty years earlier.

This one did not occur on national television. Its architects were little-known monetary officials. But it gave us the independent monetary authority that many think of as essential. The story is worth telling in some detail, because it demonstrates the danger of political capture of the central bank.

The Federal Reserve was essentially a tool of the Treasury through World War II and its aftermath. It not only committed to a short-term rate of 0.375 percent, but set an upper limit of 2.5 percent on bonds. This accommodative policy enabled the government to finance the war and the recovery, but in the late 1940s it led to severe inflation.

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By 1950, the Fed was chafing to reassert control. President Harry Truman and his Treasury Secretary, John Snyder, wanted none of it. Both Truman and Snyder, an Arkansas businessman, were populists with little regard for the theory of an independent central bank. When the Korean War erupted, the dispute turned into the monetary equivalent of a shooting war.

Allan Sproul, president of the New York Fed, insisted that the Fed reassert control of monetary policy. With FOMC support, he raised short-term rates.

By September, newspapers were reporting a rift, and Fed officials were pushing for a further rate increase. This would clearly threaten the long-term rate.

With the war (and Treasury's borrowing needs) intensifying, Truman was adamant that the Fed publicly guarantee the 2.5 percent bond ceiling—which meant monetizing bonds at the pegged rate. The president tartly observed to Thomas McCabe, the Fed chairman, that raising rates was "exactly what Mr. Stalin wants."

In January 1951, even as inflation accelerated, Secretary Snyder assured the public that Chairman McCabe had agreed to maintain the bond rate. The trouble with this soothing communiqué was that it was false. Marriner Eccles, a Fed governor, retaliated by testifying, in public, that requiring the Fed to purchase at the pegged rate would turn the entire banking system into "an engine of inflation."

A furious Truman summoned the FOMC to the White House. With the military situation deteriorating, Truman told the bankers the present emergency "is the greatest this country has ever faced."

The following day, the president announced that the FOMC had "pledged … to maintain the stability of Government securities." Eccles bluntly informed the press that the Fed had done no so such thing.

Snyder's minions in Congress turned up the heat. Wyoming's Senator Joseph O'Mahoney (D) charged that the Fed, by spurring disunity, was doing the Soviets' work of wrecking the capitalist world. The FOMC defiantly replied by quoting economist John Maynard Keynes: "The best way to destroy the Capitalist System was to debauch the currency."

By now, the Treasury realized that the public war was damaging its credibility. In March, the two agencies

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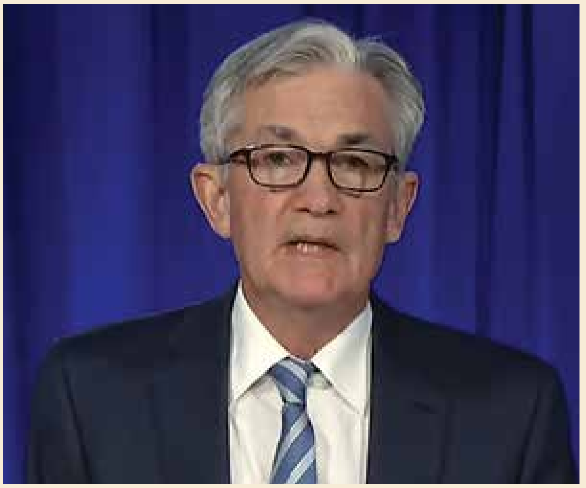

Federal Reserve Chair **Jay Powell** *participates in the virtual Federal Open Market Committee press conference on June 16, 2021.*

From Greenspan to Powell

Fed Chairman Alan Greenspan initiated the interagency fusion by avidly hobnobbing with cabinet members and presidents. His successor Ben Bernanke worked closely with the Treasury, but that was during a genuine crisis—the mortgage collapse. Since then, the Fed has not reestablished its prior distance. Suasion is barely necessary—the sense of shared mission has been internalized. Co-option might have been expected during the pandemic, but it has morphed into a follow-on mission to support a Biden New Deal.

—R. Lowenstein

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signed an accord that spelled the end of Fed subservience on interest rates. The price of the Treasury's submission was McCabe's resignation. Truman replaced him with a Treasury official, William McChesney Martin, whom he expected to be his agent. Instead, Martin became the poster boy of central banking independence, and the modern era was born.

The accord did not spell the end of executive pressure. Post-Truman, interference took two forms. The first was secretive and forceful. The second is what I'll call soft monetary suasion. In the mid- to late 1960s, President Lyndon Johnson subjected Martin to overt pressure, bludgeoning him to underwrite his wars on poverty and in Vietnam. Martin's accommodation weakened the dollar overseas, leading, eventually, to Nixon's Sunday night surprise.

Powell is essentially using the playbook from the Bernanke-Yellen years. Yet this crisis is palpably different. The mortgage bubble had its origins in finance, and the banking sector was so damaged that a decade of Fed stimulus barely budged the inflation rate. The recent economic crisis was caused by a bug.

Nixon himself, the following year, ordered his Fed chief, Arthur Burns, to loosen policy to assure his re-election—sparking the more serious inflation of the 1970s. In a 1979 address, Burns, by then deposed, lamented that central bankers around the world were failing because democratic leaders were unwilling to alienate voters.

Since Nixon, strong-arming has gone out of a favor. (Donald Trump was an exception.) The greater threat to independence is from "soft suasion," or the use of a crisis to sustain a sense of a shared mission between the Fed and the administration. The perceived mission involves a third party—fear of upsetting markets and triggering a so-called taper tantrum.

It's fair to expect the Fed to play the good soldier during a genuine crisis. But the common definitions for crisis—an "emotionally significant event" or a "decisive moment"—connote a temporal occurrence. In the modern era, Fed co-option seems to be institutionalizing. The crises never end.

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To the extent the Fed is coopted, this will heighten politicization in the fraternity of central banks globally. This may be what other governments want—but it will not be to their long-term benefit. Although America's financial preeminence is challenged, its still-unique status as a reserve currency and (tottering) leader of the democratic world mean the Fed has a unique responsibility to maintain international stability.

Were the Fed to abandon the hard-won gains of 1951, it could lead to a serious echo of the inflationary epidemic, ultimately international, that flowed from the Nixon shock. Today, the pandemic has receded, the economy is growing (the Fed estimates) at 7 percent for the year, and the United States is adding a half-million jobs a month. Yet the Fed has maintained an interest rate of approximately zero. Moreover, it is monetizing Treasury issues faster than Snyder ever dreamed of.

Fed Chair Jerome Powell is essentially using the playbook from the Ben Bernanke-Janet Yellen years—invisibly low interest rates and massive bond purchases. Yet this crisis is palpably different. The mortgage bubble had its origins in finance, and the banking sector was so damaged that a decade of Fed stimulus barely budged the inflation rate. From 2010–2019, annual money [M2] growth remained under 6 percent. The recent economic crisis was caused by a bug. The vaccine for the bug inoculated the economy, such that the Fed's medicine delivered dramatically different results. Now we have 26 percent money growth (in the year to February 2021), and further growth this year. More money means inflation and that is what we got.

As of May, consumer prices were up 5 percent in a year and core inflation at its highest in three decades. Fed policy is geared toward workers, yet inflation is eating up wage

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gains, which are negative in real terms. Meanwhile, asset prices—the unsolved riddle of modern central banks—are on a tear. Housing prices are roaring, junk bonds have touched record low yields, bitcoin is insane. In the wake of such news, the Fed plans to continue buying $40 billion a month in mortgage-backed securities and to maintain free money for another two years.

Once, with Congress gridlocked, Bernanke plausibly argued he was the only game in town. Today, Congress is flirting with record deficits. Powell and Treasury Secretary Yellen are effectively teammates in the same game. Powell has cheered the Biden stimuli and financed it, since March 2020, with a nearly $3 trillion expansion of its balance sheet. The two officials use the same lingo ("transitory" for inflation, "anchored" for expectations). So confident is the administration of Fed support that the administration forecasts negative short-term real rates for a decade.

Biden is within his rights to spend; he was elected. The central bank, by design, is not responsible to voters. One of its two statutory functions, maintaining stable prices, requires a modicum of independence. Maybe inflation will recede, or maybe it will become a habit. No one knows, not the opiated bond market bulls and not government economists. Uncertainty is a permanent truth, but the Fed's stance implicitly weights its own forecasts above the knowable facts. Chairman Powell might consider the courage of his unsung predecessors. In 1951, his agency would observe, policymakers feared another Depression, but "The primary postwar problem turned out to be inflation." ◆