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Marriner S. Eccles and the 1951 Treasury–Federal Reserve Accord: Lessons for central bank independence

by

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ABSTRACT

The 1951 Treasury–Federal Reserve Accord is an important milestone in central bank history. It led to a lasting separation between monetary policy and the Treasury's debt-management powers and established an independent central bank focused on price and macroeconomic stability. This paper revisits the history of the Accord and elaborates on the role played by Marriner Eccles in the events leading up to the Accord. As chairman of the Board of Governors since 1934, Eccles was also instrumental in drafting key banking legislation that enabled the Federal Reserve System to assume a more independent role following the Accord. The global financial crisis has generated renewed interest in the Accord and its lessons for central bank independence. This paper shows that Eccles' support for the Accord—and central bank independence—was clearly linked to the strong inflationary pressures in the US economy at the time, and that he was equally supportive of deficit financing in the 1930s. This broader interpretation of the Accord holds the key to a more balanced view of Eccles's role at the Federal Reserve, where his contributions from the mid-1930s up to the Accord are seen as equally important. Accordingly, the Accord should not be viewed as the final triumph of central bank independence, but rather as an enlightened vision for a more symmetric policy role for central banks, with equal weight given to fighting inflation and preventing depressions.

Keywords: Marriner Eccles; Central Banking; Monetary Policy; Fiscal Policy

JEL Classifications: B31, E52, E58, E63, N12

INTRODUCTION

The Accord between the US Treasury and the Federal Reserve announced on 4 March 1951 has been hailed as "the start of the modern Federal Reserve System" (Hetzel and Leach 2001, 53) and as "a major achievement for the country" (Meltzer 2003, 712). It led to a lasting separation between monetary policy and the Treasury's debt-management powers and established an independent central bank focused on price and macroeconomic stability.

Marriner S. Eccles was a key player in the events that led up to the Accord. As chairman of the Board of Governors since 1934, he was instrumental in drafting key banking legislation in the mid-1930s that enabled the Federal Reserve System to take on a more independent role following the Accord. He was reappointed to the chairmanship twice by Franklin D. Roosevelt, though not by Harry S Truman in 1948. He remained on the Board as an ordinary member, where he increasingly opposed the Administration's inflationary war financing. When the conflict with the Treasury came to a head in spring 1951, he acted with integrity and determination to save the independence of the Federal Reserve. His role in this drama is somewhat surprising, since he started his career at the helm of the Federal Reserve as a "fiscalist" who preached deficit financing and monetisation of government debt. But as we shall see, his position was quite consistent when seen in a broader cyclical perspective, as he was equally concerned with inflation and deflation.

Before the recent financial crisis, the history of the Accord and the importance of the conflict between the Federal Reserve and the Treasury were largely relegated to the history books.[1] But the global financial crisis has generated renewed interest in the Accord and its relevance for current policymaking. The crisis has also prompted renewed discussions about central bank policies and organisation. Gillian Tett of the *Financial Times* has noted that the analytical framework for central bank policies needs updating or even a radical overhaul (Tett 2011) and a recent Brookings report argues that the conventional approach to central banking needs to be rethought (Brookings Institution 2011, p. 2).

The huge expansion of central banks' balance sheets has led some to question the wisdom of unconventional monetary policy, since they are concerned that the principle of

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[1] The key resource for any study of the Accord is Meltzer (2003). There is also a special issue of the *Economic Quarterly* of the Federal Reserve Bank of Richmond commemorating the 50th anniversary of the Treasury-Federal Reserve Accord (Kramer 2001). The electronic archive of the Federal Reserve Bank of St. Louis contains a wealth of relevant information; http://fraser.stlouisfed.org/. The autobiography by Marriner Eccles (1951) and the later biography by Sidney Hyman (1976) give a more personal perspective on the creation of the Accord. Reich (2011) includes a chapter on the relevance of Eccles' ideas for the current financial crisis.

central bank independence is in jeopardy (Goodfriend 2011). Stephen Cecchetti of the Bank for International Settlements (BIS) observed that “the subsidy implicit in the loan to Bear Stearns was clearly a fiscal, not a monetary operation; the Federal Reserve is effectively acting as the fiscal agent for the Treasury” (Cecchetti 2009, 70). And Hervé Hannoun, also of the BIS, adds that

> [a]voiding fiscal dominance[2] will require decisive steps by central banks, but also by other policymakers. Central banks will need to restore a clearer separation between monetary and fiscal policy. … The bottom line is that monetary policy should be refocused on maintaining lasting price stability. (Hannoun 2012, 20-1)

Marvin Goodfriend of the Richmond Federal Reserve has long argued for a “New Accord” to limit the central bank’s ability to use its balance sheet for unconventional monetary policies. His basic idea is that “Congress has provided the Fed with the independence necessary to carry out central bank functions effectively, and the Fed should perform only those functions” (Goodfriend 2001, 31). In a recent paper, he reiterates his proposal for a new accord that would seek “to clarify and limit the Fed’s credit policy powers and preserve its independence on monetary and interest rate policy”. In his view, "an independent central bank cannot be relied upon to deliver or decide upon the delivery of fiscal support for the financial system” (Goodfriend 2011, p. 3).

A new credit accord that assigns to the Treasury the responsibility for all but very short-term lending to solvent institutions would have a number of advantages, according to Jeffery Lacker of the Richmond Fed (Lacker 2009, p. 7). Mervyn King of the Bank of England adds that the central bank “has no democratic mandate to put taxpayers’ money at risk” and he “rather doubts that central banks’ independence would survive the extension of their responsibilities into areas that are the proper domain of government” (King 2012, p. 4).

This interpretation of the 1951 Accord as the ultimate inspiration for central bank independence—at all times—is in my view somewhat ahistorical. Eccles’s support for the Accord—and central bank independence—was certainly motivated by the fact that the economy at that time had close to full employment and strong inflationary pressures. Thus, his support for tight monetary policy in the early 1950s was perfectly consistent with Federal Reserve support for government deficit financing in the 1930s when there was enormous slack in the economy. For him, it was “the duty of the Government to intervene in order to counteract as far as possible the twin evils of inflation and deflation” (Eccles 1935c, p. 1).

[2] “Fiscal policy will become active and monetary policy passive, also referred to as a situation of fiscal dominance” (Bordo 2011, p. 49).

The Accord "solved" the acute conflict with the Treasury and gave the Federal Reserve control of monetary policy to fight inflation. But the Accord should not be viewed as the final triumph of central bank independence, but rather as an enlightened vision for symmetric policy response, with equal weight on fighting inflation and preventing depressions.

This broader interpretation of the Accord holds the key to a different view of the Accord, where Eccles's contributions from the mid-1930s up until the date of the Accord are seen as equally important.[3] Central bank independence is important, but not as an absolute virtue. Eccles favoured a broad objective for central banks, including maximum employment and price stability, and he valued the Federal Reserve's independence insofar as it supported this broad objective. He therefore preferred a coordinated approach between fiscal and monetary policy to achieve full employment and "a decent living for every working man and woman." This strong moral stance is his lasting legacy and also his primary message to policymakers facing depressed economies and mass unemployment.

Today, monetary and fiscal authorities in Europe and the US are locked in an "elaborate pas de deux"[4] as they try to agree on adequate policy responses to the massive unemployment problem. This high-stakes poker game between central bankers and politicians has all the ingredients of the drama leading to the Accord; this time, however, the difference is that advanced economies are facing high unemployment and low inflation. Eccles would surely have concluded that central bankers today are drawing the wrong lessons from the 1951 Accord, and that they should rather heed his policy advice from the Depression years when he advocated deficit financing and accommodative monetary policy.

> The problem with this prescription of course is that it goes against decades of deeply entrenched economic orthodoxies – that balanced budgets and central bank independence are always good and that monetary financing of deficits are always inflationary.[5] (McCulley and Pozsar 2012, p. 12)

A review of Eccles's policy views and the history of the Accord should therefore give us a better background for understanding what the Accord was all about and its

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[3] Vernengo (2006) provides supporting evidence for this interpretation of Eccles' policy views. Epstein and Schor (2011) add to this perspective.

[4] "The political limits of central bankers", *Financial Times*, 8 June 2012, http://www.ft.com/intl/cms/s/0/35023848-b177-11e1-9800-00144feabdc0.html#axzz25Vp6kH6H

[5] *Monetary financing (monetisation)* is a two-step process where the government issues debt to finance its spending and the central bank purchases the debt, leaving the system with an increased supply of base money.

relevance for the ongoing discussion of central bank independence and monetary policy reform.

This paper is structured in five parts. First, I provide an overview of Eccles's early "Keynesian" views and his theory of compensatory monetary and fiscal policies. Then I review the process leading up to the 1935 Banking Act and highlight the parts of special importance for the future independent Federal Reserve. Third, I review Eccles's views on war financing and the way the Second World War was actually financed in the US. This leads up to the fourth part: "the battle of the peg" and the drama that led to the 1951 Accord. The last part concludes with an assessment of Eccles's role in the making of the Accord, and a discussion of the lessons we should draw today for central bank independence and the conduct of monetary policy.

MARRINER ECCLES–A HETRODOX CENTRAL BANKER

Marriner S. Eccles was born in 1890 in Logan, Utah. His parents settled there when they came from Scotland in the 1860s, together with other Mormons who were in search of a better life in the US. Through hard work and perseverance, his father became a leading industrialist, with numerous enterprises in lumber, construction, livestock and sugar refining. Although Marriner was only twenty-two years old when his father died (in 1912), he was quick to take command of his father's extensive business interests. He stabilised their operations and soon expanded into banking. Following a string of bold acquisitions, he built the first bank holding company in the US - First Security Corporation - and thus became the leading banker in the West.

The Great Depression hit the banking industry hard, but against all odds, Eccles was able to keep all his banks open. Even so, he observed how his customers were struggling, with no end in sight. As the crisis persisted, he gradually became convinced that private thrift and hard work were not enough to lift the economy out of the Depression. Able, thrifty people were unable to find work, and private relief was woefully inadequate. He gradually developed a more radical view of the defects of the capitalist economy and concluded that only the government could initiate a recovery.

Early “Keynesian” views

Eccles developed his economic views independently of contact with Keynesian theory or the academic debate in the US at the time.[6] His views were surprisingly radical and bear striking similarities to Keynes’s later policy prescriptions in *The General Theory of Employment, Interest and Money*.

Causes of the Great Depression

According to Eccles, the Depression was primarily the result of “a lack of balance between our capital or our ability to produce and our ability to consume.” When workers lack the means to consume, production is held back, not by a lack of desire, but because of a lack of purchasing power. For a period, this imbalance could be sustained by large amounts of credit. Novel ways of extending credit were developed, such as instalment credit, which made it possible for prosperity to continue for a little while longer. But “eventually you reach the point of saturation—because you cannot keep up forever the process of consumption on the basis of credit”. When credit dries up and debtors start deleveraging, purchases are curtailed; unemployment follows, and thus begins a vicious downward spiral which forces down prices and wages and reduces the ability to pay as time passes (Eccles 1933, p. 705-6).[7]

Eccles argued that a skewed production structure had developed, characterised by an excess of resources devoted to the production of capital goods financed by cheap credit. When the crisis finally hit, debtors were forced to curtail their consumption in order to deleverage. The result was overproduction of goods relative to available income, and a mismatch between the goods being produced and the goods consumers needed. The economy was left with the intractable problem of excessive debt and a lack of effective demand.

> People are not going to use credit to put men to work until they get a demand for the thing they produce, and they are not going to get the demand for the thing they produce until you create employment and give buying power to the consumer. (Eccles 1932, p. 5)

[6] Eccles claimed that, at the time, he had never read any work of J. M. Keynes (Eccles 1951, p. 132). However, even though the idea that the government should compensate for the lack of effective private demand in a depression was developed independently by American economists at the University of Chicago during the early 1930s, it is not known if Eccles was familiar with their various memoranda (issued in 1933 and 1934); see also Hyman (1976, p. 128-9).

[7] This explanation of the causes of the Depression is surprisingly relevant as an explanation for the current global recession.

The problem of unequal income distribution

Eccles was particularly concerned that the serious "maldistribution of incomes was increasing the economy's susceptibility to booms and collapses". Money saved by the rich would in large part go into idle balances, reducing effective demand. "If income had been more evenly distributed and corporations not so large and wealthy, more of the current income would be spent for consumer goods and a smaller proportion on durable capital goods". This would lead to more balanced growth and less unemployment (Eccles 1935b, p. 19).

He was very critical of the sharp reductions in corporate and inheritance taxes in the late 1920s and argued that these had "primarily benefited the rich and led to excessive wealth accumulation". Combined with the Federal Reserve's lax monetary policies in 1927 and 1928, which facilitated an unnecessary and undue expansion of credit, these tax reductions had set the economy up for the Great Depression (Eccles 1932, p. 3). According to Eccles, the inequality in incomes was not generally appreciated at the time. He referred to a Brookings study (Leven, Moulton and Warburton 1934), which showed that in 1929, 0.1 percent of the families at the top received as much as the 42 percent at the bottom. "It is obvious that only a small portion of the incomes of the one-tenth of one percent is spent on consumer goods. It is for the most part saved. If this saved money is not spent on producer goods it is not spent at all. The consequence is an increase in unemployment and reduction in incomes" (Eccles 1935b, p. 20).[8]

Only the government can initiate a cyclical recovery

Eccles was particularly frustrated with the politicians in Washington who promised to end the Depression by balancing the budget. And in this regard, the Democrats were as bad as the Republicans. In fact, Roosevelt used even stronger balanced budget rhetoric than Herbert Hoover when he ran for president in 1932:

> High-sounding, newly invented phrases cannot sugarcoat the pill. Let us have the courage to stop borrowing to meet our continuing deficits. … Revenues must cover expenditures by one means or another. Any government, like any family,

[8] Following Roosevelt's New Deal policies, this trend was reversed and for many years the top 1 percent of income earners in the US received no more than around 10 percent of total income. After 1986, this changed, and by 2007 the share was again close to 20 percent (18.3), compared with 19.6 percent just before the Great Depression, see http://g-mond.parisschoolofeconomics.eu/topincomes/#Graphic (World Top Income Database). A recent study by the Congressional Budget Office (2011, ix) found that most of the income growth between 1979 and 2007 went to the top 1 percent of the US population. As a result, the distribution of after-tax household income in the United States was substantially more unequal in 2007 than in 1979.

> can for a year spend a little more than it earns. But you and I know that a continuation of that habit means the poorhouse. (Roosevelt, as quoted in Eccles 1951, pp. 96-7)

In early February 1933, one month before Roosevelt took the oath of office, Eccles was invited to present his views before the Senate Committee on Finance. All the other two hundred invited speakers from the banking and manufacturing sectors preached the gospel of balanced budgets. Eccles noted, however, the huge waste resulting from idle resources, which substantially reduced purchasing power and prevented consumers from purchasing the goods necessary to sustain production. And he challenged the politicians in Congress: "Is there any program of our Government as important as to stop this great loss and all the attendant human suffering, devastation, and destruction?" (Eccles 1933, p. 719).

Eccles wanted "bold and courageous leadership" that could increase government spending on a scale sufficient to increase incomes and the demand for goods. This would absorb unused capacity and make it profitable for business to expand. And more jobs would mean incomes for more people, increasing the demand for new homes, which could help the construction industry regain its profitability (Eccles 1935b, p. 14).

The need for more purchasing power

According to Eccles, a sharp increase in the purchasing power of ordinary people was required to restore the economy to health. Unless there was effective demand for the goods that could be produced, there would be no new production and therefore no income either. "Unless you create employment, there will be no buying power of the consumer" (Eccles 1932, p. 5). The increased purchasing power would result in more production and even more national income. And, noted Eccles, "only then and not before can the Government hope to balance its budget and our people regain their standard of living" (Eccles 1933, p. 705).

He later noted that the circular flow of money would be broken unless money was spent. "Demand will not be sufficient unless business distributes its income to the people, and unless the people return their incomes to enterprise in the purchase of its goods and services. This means, first of all, maintenance of a high volume of wages" (Eccles 1944, p. 5). Thus, the basis for economic prosperity is a steady stream of expenditures sufficient to employ all who desire work. "The more fully private enterprise succeeds in providing the necessary volume of income and expenditures, the less necessary it will be for Government—Federal, State and local—to provide supplementary employment" (*Ibid*.).

There were many who criticised his programme of deficit financing and government borrowing. Eccles responded that if governments could legitimately spend billions on armament during wars, they "surely should be justified in supplying sufficient credit or money to take care of the unemployed through public works, or an unemployment wage or a combination of both" (Eccles 1932, p. 6). "The protection of life and property of its citizens in times of depression and distress such as we have today, and the rebuilding of our economic and social and political structure, is as much the business of our government as it was at the time of the war period" (*Ibid*., p. 5).

A nation cannot go bankrupt

Eccles was accused of being a socialist and his proposals would, according to his opponents, surely destroy the good credit standing of the US government.[9] His argument, however, was that his critics failed to see the economy as a whole. When the government borrows money, according to Eccles, "we borrow from ourselves, and when we pay interest on or pay back the principal of the debt thus created, we are paying ourselves" (Eccles 1938, p. 4).

> If a man owed himself he could not be bankrupt, and neither can a nation. We have got all of the wealth and resources we ever had, and we do not have the sense, the financial and political leadership to know how to use them (Eccles 1932, 5).

Eccles argued forcefully that only the US federal government had the money-creating powers that could end the depression by the use of public credit on a national scale. Individual (US) states could not act in this way. They could not call men to war or provide billions for that purpose. Only the federal government had this power. And, Eccles added, "the longer it waits, the greater will be its difficulties when it gets around to doing it" (Eccles 1951, p. 106).[10]

At the 1933 hearing before Congress, he noted that "the Government controls the gold reserve, the power to issue money and credit, thus largely regulating the price structure". It should use this power of taxation to jumpstart the economy and mobilise the resources of the nation for the benefit of its people (Eccles 1933, p. 707).[11]

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[9] Eccles was famously rebuked by Congresswoman Jessie Sumner (R, IL) during a House of Representatives hearing on the "increasingly big-government, statist" policies of the Roosevelt Administration and the Federal Reserve, when she said, "you just love socialism" (Woods 1990, p. 136).

[10] Some have argued that the current problems in the euro area are similar to the problems of individual US states, as European Union member states have as little power to issue money as local US states; they are using a currency that is controlled by an outside entity (in the US, the federal government; in the EU, the European Central Bank). For a recent review of the problems inherent in the euro area, see Papadimitriou and Wray (2012). For an early critique of the euro project, see Godley (1992).

[11] James Tobin (1950, p. 556) expressed similar views when he reviewed the congressional report on the national debt in 1950: "A national debt is a burden on the nation analogous to the burden of private debt only if the nation is in debt abroad. … Happily the 250 billion dollar (US war debt) is owed by the Government to its

The need for compensatory policies

Despite his background as a banker and industrialist, Eccles was led to policy views that would only later be embraced wholeheartedly by the Roosevelt Administration. He argued that unless the government stepped in to prevent them, “booms and collapses will continue to occur in capitalistic democracies”.

> Therefore it is absolutely essential to develop agencies which by conscious and deliberate compensatory action will obviate the necessity of drastic downward or upward adjustments of costs and prices, wages, and capital structures (Eccles 1935b, p. 1).

He reasoned that these agencies would need to be guided by the public good, “since it is the unguided profit motive which intensifies upswings and downswings.” When the private sector withdraws its purchasing power, only the government and the Federal Reserve System can serve as “counteracting or compensatory forces” (Eccles 1935b, p. 17). The Government’s fiscal policies should contribute to stability, rather than intensify business fluctuations, and the Federal Reserve banks should vary the supply of money so that loans are available to individuals and corporations on reasonable terms.

This compensatory force would lead the government to “counteract big increases or decreases of expenditures on the part of the community by varying its own expenditures”. He noted that “posters and placards” that urged individuals to spend more would fail, since they were simply constrained in their spending by lack of income and the high debt burden. The government, however, could safely borrow and increase its expenditures—“since it was all of us”.

The Federal Reserve should act as a compensatory agent by taking control of the money supply and influencing the rate of expenditures in the economy. But Eccles also observed the inherent limitations of monetary policy, noting that it would work best when “business is going along smoothly.” If “business takes a nose dive”, the cost of borrowed money becomes a minor factor in the calculations of producers, and there is little that the monetary authorities can do. The hoarding and dishoarding of idle cash balances by large business corporations would also make it difficult to keep up “an even flow of money.” Fiscal measures would then be required to restart the money stream (Eccles 1936, pp. 6-7).

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own citizens. … Payment of interest are not an external drain on our production, and, thanks to the lending power of the Federal Reserve System, the Government need never encounter difficulty in refinancing existing debt or in borrowing more money”. Note the striking similarity to the current situation in Japan.

A five-point plan for recovery

Eccles then proposed a five-point plan to Congress to end the massive unemployment and bring the economy back on track (Eccles 1933, pp. 712-13). Due to the urgency of the problem, he pleaded with them to adopt these measures immediately:[12]

1. Make ample funds available to all states to be used for the destitute and unemployed, pending a revival in the economy.
2. Allocate funds for public works to cities, counties, and states on a liberal basis at a low rate of interest.
3. Adopt a plan to regulate agricultural production and raise prices.
4. Refinance mortgages on an immense scale and on a long-term basis at a low rate of interest.
5. Permanent settlement of sovereign debts on a sound economic basis, cancellation being preferable.

He urged Congress in particular to deal with the huge (inter-allied) debt problem, noting that "the public is not fully informed as to the impossibility of our foreign debtors complying with these demands" (for repayment) (*Ibid*., p.728). Their debt can only be paid back in goods, gold, or services, or a combination of the three. "Debtor countries will thus try to meet their obligations by producing and selling more than they buy from us" (*Ibid*., p.729). This would, however, hurt US industries and have a depressing effect on the domestic economy. For that reason, Eccles argued for full debt cancellation to mitigate this negative effect at home, "thus allowing our economy, as well as theirs, to prosper".

> We must either choose between accepting sufficient foreign goods to pay the foreign debts owing to this country, or cancel their debts. This is not a moral problem, but a mathematical one. A cancellation of these sovereign debts owed to us would greatly benefit our economies and help reduce unemployment both in the debtor and creditor nations. A comparatively small portion of our population would make up this loss to the Treasury through the payment of income and inheritance tax which would be made productive by the revival of business. (*Ibid*.)

He also urged Congress to deal head-on with the domestic debt problem and initiate debt restructuring there as well. His proposal for debt restructuring would reduce annual debt payments by at least one-third and make liquid millions in assets for which there was currently no market. This, together with the plan to raise agricultural prices, would save the

[12] *TIME* Magazine (1936) noted in a cover story that the Eccles' plan laid out before the Senate committee in 1933 "turned out to be nothing less than a detailed blueprint of the New Deal", although it took several years to get FDR to fully embrace the idea of deficit financing.

entire agricultural industry from what would otherwise be a general collapse, and at the same time greatly expand purchasing power in the farming sector, thus helping to bring about a revival of the general economy (*Ibid.*, p. 728).

He noted at the end of his address that Congress needed to act quickly by addressing the debt and unemployment problem—"or we are going to get a collapse of our whole credit structure" (*Ibid.*, p. 732). "We shall either adopt a plan which will meet this situation under capitalism, or a plan will be adopted for us which will operate without capitalism. … We simply have to take care of the unemployed or we will have a revolution in this country" (*Ibid.*, p. 713, p. 733).

Architect of the new Federal Reserve

The transition to Washington

After his presentation before Congress in February 1933, Eccles returned to Utah and resumed his business activities. The following month, on 5 March, Roosevelt declared a nationwide bank holiday for 6 March, two days after his inauguration. Four days later Congress passed *The Emergency Banking Act,* which gave the President emergency powers to regulate credit, currency, and foreign exchange. After the bank holiday, most sound banks reopened with government guarantees, while others remained closed and were wound up. Eccles supported these policy measures, but was appalled by Roosevelt's continued balanced budget rhetoric. He wrote an angry note to his business associates, with copies to his political friends in Washington, stating that "it seems to me that if the proposed budget-balancing policy is carried out, it can only result in further drastic deflation, a further decrease in buying power and a great increase in unemployment" (quoted in Hyman 1976, p. 117).

His perseverance and constructive criticism finally landed him an appointment in Washington later the same year with key New Dealers, including Rexford Tugwell, a close adviser to the President. During a series of meetings with Tugwell, Eccles repeated his arguments for government-planned deficit financing. At the end of his visit, Tugwell raised the possibility of Eccles joining the Administration in Washington. Eccles was reluctant, and they parted without any firm deal. But by the end of the year, Eccles received a telegram from the Treasury Department asking if he would come to Washington to discuss certain monetary matters with the new acting Secretary of the Treasury, Henry Morgenthau, Jr.

After a further series of meetings in Washington, Eccles was finally convinced to act and not just talk. And so, beginning on 1 February 1934, Marriner S. Eccles, the millionaire and industrialist from Utah, was appointed Assistant to the Secretary of the Treasury at an annual salary of USD 10,000. Initially, Morgenthau asked him to review the human resource situation at the Treasury Department, but soon Eccles was occupied with key monetary and banking legislation. This included what would become the National Housing Act, which established the Federal Housing Administration and made possible a new way of financing residential construction in the US.

Eccles' assignment at the Treasury was meant to be of only one year's duration, but later that year the Chairman of the Board of Governors of the Federal Reserve System resigned and the Administration began searching for a replacement. Eccles was one of the candidates considered, but when the President asked if he was interested, he politely rejected the offer.[13] He told the President that private banking interests, particularly the large New York banks, currently dominated the Board. The Board was therefore not in a position to impose public control on monetary policy. It could recommend open market operations, but the regional banks could decide not to go along (Hyman 176, p. 155).

However, Eccles added that if Roosevelt would support changes to the Federal Reserve System, then he would "welcome any consideration you might give to my personal fitness to serve as governor of the Federal Reserve Board" (*Ibid*.). The President was intrigued by this unconventional reaction and asked Eccles which specific changes he had in mind. Eccles asked for some time and went back to work on a proposal for a radical overhaul of the Federal Reserve System. In a meeting with the President on 4 November of the same year, he brought with him a memorandum prepared with the help of his assistant Lauchlin Currie[14] called "Desirable Changes in the Administration of the Federal Reserve System" (Currie [1934] 2004). This was to form the backbone of Title II of the new Banking Act of 1935, which would create a new and more accountable Federal Reserve System.[15]

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[13] He told the President that he "would not touch the position of Governor with a ten-foot pole unless fundamental changes were made to the Federal Reserve System" (Hyman 1976, p. 155).

[14] Currie was a Canadian economist, trained at the London School of Economics and Harvard University. He was an early advocate of government deficit financing during the depression and went on to become Eccles' assistant at the Federal Reserve Board, and later the first economist in the White House, a job that would later become part of the Council of Economic Advisors.

[15] Roosevelt shrewdly combined the proposal for reforming the Federal Reserve System (in Title II of the Act)—which would not easily pass in Congress—with two other proposals that both bankers and Congress favoured. Title I amended the permanent deposit insurance provisions of the Banking Act of 1933, while Title III mostly consisted of technical amendments. Both Titles I and III were eagerly awaited by the banking community, with the deadline of 1 July putting pressure on the legislative process in Congress.

Agitation for central banking

The memorandum argued that the monetary system should be used to promote business stability. Experience had shown that without public control, the supply of money tended to expand in booms and contract in depressions. Production, employment, and national income were determined by the available supply of cash and deposits, and the supply should be adjusted to achieve the desired level of income and employment.

The Federal Reserve Board should be strengthened to secure the required degree of centralised control of monetary policy to support the ongoing emergency programme. The Board (in Washington) should be given complete control over the timing, character, and volume of open market operations, and regional presidents should be appointed annually and be subject to the approval of the Board.

These changes were necessary to give the Board full control of open market operations, since such policy decisions at the time included some hundred persons at the regional level. The reform proposed by Currie and Eccles would instead concentrate the authority and responsibility for monetary policy in Washington.

> These suggestions would "introduce certain attributes of a real central bank capable of energetic and positive action without calling for a drastic revision of the whole Federal Reserve Act. Private ownership (of the regional Reserve banks) and local autonomy are preserved, but on really important issues of policy authority and responsibility, they would be transferred to the Board. (Currie [1934] 2004, 269)

For two full hours Eccles explained his memorandum to Roosevelt. The president listened intently and then finally slapped his powerful hands down on the table in his characteristic gesture of decision and said, "Marriner, that's quite an action program you want. It will be a knock-down and drag-out fight to get it through. But we might as well undertake it now as at any other time."[16]

By agreeing to this proposal, Roosevelt accepted the creation of a central monetary authority with a fairly high degree of independence. His and Eccles's ideas were to centralise control in Washington away from the banking-dominated New York Federal Reserve, and to move the Federal Reserve closer to the Treasury. But some of the changes that were later made by Congress also made the Federal Reserve more independent of the Administration,

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[16] From Utah State History, *People Who Made a Difference: Marriner S. Eccles*. Available at http://history.utah.gov/learning_and_research/make_a_difference/eccles.html.

and thereby opened up the potential for future conflicts between these two “strong-willed” institutions.[17]

Public control of money

Eccles noted that the government had a responsibility to promote business stability. The Depression had shown that the financial system was unstable when left on its own and that individual thrift, economy, and hard work were not the right recipe for recovery.

> The economics of the system as a whole differ profoundly from the economics of the individual; that what is economically wise behavior on part of a single individual may on occasion be suicidal if engaged in by all individuals collectively; that the income of the nation is but the counterpart of the expenditures of the nation. If we all restrict our expenditures, this means restricting our incomes, which in turn is followed by further restrictions in expenditures. (Eccles 1937, 4)

According to Eccles, booms and collapses were a recurring feature of capitalist democracies unless a conscious effort was made to prevent them. Only compensatory action from the government, including an active countercyclical monetary policy, could stabilise the economic system. “The banking system should be one of our chief instruments for the promotion of stability” (Eccles 1935a, p. 2).

Left to itself, the banking system tended to propagate business fluctuations. In good times, banks would lend more, thus increasing their assets as well as their deposit base. Eccles noted that “laissez faire in banking and the attainment of business stability are incompatible. If variations in the supply of money are to be compensatory and corrective rather than inflammatory and intensifying, there must be conscious and deliberate control” (*Ibid*., p. 3).

The power to coin money and regulate its value had always been an attribute of the sovereign power. With the development of deposit banking, however, private agencies had gained the power to create and destroy money without due regard for the consequences for the economy as a whole. Eccles wanted to re-establish the primacy of the State in monetary affairs, and bring the issuance of money under democratic control. By centralising power with the Federal Reserve Board, its status would be enhanced as well as its ability to influence the volume of reserves. The new Federal Reserve Board would design monetary

[17] Meltzer (2003, p. 484) notes that Morgenthau supported the bill to get an ally in financing the government’s budget deficits. He wrote in his diary: “I have been hoping and have not mentioned it to a soul that the Federal Reserve would be given additional powers … so that they and the Treasury can share the responsibility and possibly help us in case we get into a financial jam”.

policy with the intent of influencing the behaviour of private banks, so as to counteract their pro-cyclical behaviour. For this to succeed, Eccles needed to shift power from the regional Federal Reserve banks to the centre of the System. And the Banking Act was the vehicle for this “grand reform” (*Ibid.*, p. 4).

> A policy of laissez faire in banking presupposes an economy possessing a flexibility that I think it is hopeless for us to expect to achieve. Therefore it is absolutely essential to develop agencies that by conscious and deliberate compensatory action will obviate the necessity of drastic downward or upward adjustments of costs and prices, wages and capital structures. If we do not develop such agencies, our present economy, and perhaps even our present form of government cannot long survive. (Eccles 1935a, p. 9)

The arguments for Title II

Eccles’ adviser, Lauchlin Currie, provided more arguments for Title II of the Banking Bill in a speech he gave in Philadelphia. This was obviously required, he noted, since many viewed the bill “as a sinister plot on the part of the Administration to capture and wreak the banking system in the pursuit of its own unworthy purposes” (Currie [1935] 2004, p. 281). This, according to Currie, was a grave misrepresentation of their position.

The key goal of Title II was, according to Currie, the establishment of a small and flexible monetary authority with powers to conduct compensatory variations in the supply of money to secure business stability. Its ability to conduct monetary policy should not be constrained by the particular type of loans banks might happen to have. In his view “the primary function of banks is that of supplying money and not of meeting requirements of business for any particular type of loan” (*Ibid.*, p. 281).[18]

The new monetary authority would not be subsumed under the Administration in its conduct of monetary policy, but would have to cooperate with the Administration in order to achieve its monetary objectives. But, in the current situation, “it is highly questionable whether business stability can be achieved through monetary means alone” (*Ibid.*, p. 282). Fiscal policy would therefore be the prime instrument to get the economy back on track, according to Currie.

He added that the Federal Reserve System should be more than just a provider of seasonal and emergency loans (as provided for in the original Federal Reserve Act of 1913). The Board would conduct monetary policy and not credit policy. “This change in emphasis

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[18] This was in reference to the prevailing policy of only discounting “real bills”, i.e. providing funds to banks secured with business loans; the idea was that this would somehow reduce the extent of speculative lending (see Meltzer 2003, pp. 485-486.

is absolutely vital to understanding the bill" (*Ibid*.). But credit administration and banking supervision would be delegated to the regional reserved banks.

He then addressed the "highly controversial question of the relation of monetary authority to the Government." Congress had been given the power to coin money and regulate the value thereof, but it was obvious that this power should be delegated. The question was, to whom?

> The Federal Reserve is a creation of Congress and not of the Constitution, and its duty is to carry out the will of Congress. It is necessary, therefore, that Congress retain some degree of control over the money issuing authority. The people must have some way, even though it is remote, of expressing their satisfaction or dissatisfaction with the manner in which the delegated powers of money control are being exercised. (*Ibid*., p. 286)

But it was also important to avoid undesirable political domination. Currie favoured a system where the President would appoint Board members, but they would be expected to act relatively independently. To strengthen their position, the bill provided for long terms (twelve years), increased salaries and pensions for Board members,[19] required more professional qualifications of Board members, and included an explicit objective for monetary policy.[20]

However, "the best safeguard against manipulation of monetary policy for partisan purposes would be full publicity and widespread awareness of the importance and significance of Federal Reserve policies."[21] With increased awareness of the importance of the Federal Reserve, and with the full light of publicity turned on its every action, Currie "did not think any Administration would dare to exert pressure on the board to pursue policies on political grounds" (*Ibid*., p. 286).

He concluded with a wish for the rapid passage of the bill, which would bring forward "a unified and responsive monetary system where deposits are as safe as currency, where the [policy] instruments are so good as to make compensatory monetary policy action possible, and where the controlling body will cooperate with the Government and yet be free from political domination in the bad sense of the term" (*Ibid*., p. 288).

Collateral policy and liquidity support

By relaxing the collateral requirements for rediscounting at the Federal Reserve, Eccles and

[19] Between USD 12,000 and USD 15,000 per year.
[20] See discussion below; the proposal for a new policy objective was not accepted by Congress.
[21] Cf. today's emphasis on "transparency" and "accountability."

Currie hoped to encourage banks to lend more and at longer maturities. Broader eligibility criteria would enable Federal Reserve banks to check the contraction and to make collateralised loans to member banks, secured, if necessary, by non-liquid, though safe, assets. As Currie noted, “banks must make longer-term loans to justify their existence” (Currie [1935] 2004, p. 285).

Eccles added that banks were frequently criticised when they acquired long-term assets and were advised to stick to short-dated commercial loans and investments. “But I need not tell you that this proposal, if acted upon, would be fatal for the banks” (Eccles 1935a, 8). The banking bill therefore prepared the way for commercial bank lending for real estate, as the proposal emphasised soundness rather than liquidity. As Eccles noted, “a 20-year amortized loan is safer than a straight five-year real estate loan” (*Ibid*.).[22]

The change in collateral policy would also enable the Federal Reserve System to act more forcefully in a crisis. “One of the most disastrous developments in the whole depression was the scramble for liquidity on the part of thousands of individual banks and by their very scramble effectively precluding the possibility of liquidity” (Currie [1935] 2004, p. 285). The Federal Reserve had been restricted by the collateral requirements in 1931, when there was a shortage of paper among banks that was eligible as backing for Federal Reserve notes. As a consequence, the Federal Reserve was unable to add liquidity to the market to counteract the rapid contraction of deposits at the time.

The Glass-Steagall Act of 1932 had temporarily enabled the Federal Reserve to accept government securities from open market operations as collateral (for Federal Reserve notes). Now Eccles suggested “it was realistic and desirable to do away with the collateral requirements [for notes] altogether” (Eccles 1935a, p. 7). But this did not mean that notes would be issued without adequate backing. Any increase in the note issue would be counterbalanced by a corresponding increase in Federal Reserve Bank assets. But there was no need to limit discounting to purely short-term commercial bills. This change in policy, Eccles noted, would greatly enhance the Federal Reserve System’s ability to buy securities, get member banks out of debt, and thus stem the process of deflation (*Ibid*., p. 7).

By removing the problem of liquidity from the concern of individual banks and making all sound assets eligible for discounting at Federal Reserve banks, “the banks could

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[22] The bill gave commercial banks access to the mortgage business and permitted them to make twenty-year amortized loans for up to 75 percent of the appraised value within 60 percent of their time deposit base; this was a major change in policy from the standard five-year loans that had been in place up to then.

concentrate their efforts on keeping their assets sound and pay less attention to their form and maturity" (*Ibid*., p. 9). And Eccles noted that the amount of borrowing from the Federal Reserve would be limited by the general rediscount policy, as well as the "unwritten law that borrowing should not be continuous and should be for emergency and seasonal purposes only" (*Ibid*., p. 7).

By extending the eligibility criteria for rediscounting, "the problem of liquidity shall cease to be an individual concern and shall become the collective concern of the banking system" (*Ibid*., p. 9). As Eccles noted when he presented the Bill in Congress: "The proposals in this bill are simple and concrete; without modifying the essential nature of the Federal Reserve System, they strengthen its power to meet future emergencies and increase the ability of member banks to facilitate recovery" (US Congress 1935, p. 299).

The objectives of the Federal Reserve System

There was one other change that Eccles felt was required in order to get the Federal Reserve System to focus on business stability, and not just seasonal lending and emergency credit. It was still the case under the Federal Reserve Act that the System should accommodate the monetary and credit needs of commerce, agriculture, and industry. Eccles felt very strongly that the Federal Reserve's objective should be amended to enable it to "promote business stability and moderate fluctuations in production, employment, and prices" (US Congress 1935, p. 290). A more specific objective would also enable the Federal Reserve Board to "resist political pressure for the use of its authority for purposes inconsistent with the maintenance of business stability" (*Ibid*., p. 291).

Currie added that if the new objective were written into the law, it would greatly reduce "the danger for undesirable political pressure," since every action of the Board would be extensively discussed and judged in light of this new objective. If the Board should then deliberately try to manipulate monetary policy for partisan or other unworthy purposes, it would break the law and be subject to impeachment (Currie [1935] 2004, p. 287).

This proposed change did not survive Congressional scrutiny, and there was especially strong resistance by Senator Glass. He refused to accept the new phrasing of the mandate, claiming that "it did violence to Jefferson democracy, since the effect of a change would be to give the central government too much power" (Hyman 1976, p. 188). Despite strong backing from Congressman Steagall, who was heading the review in the House, the revised objective therefore died in the Senate, and the vague mandate for the Federal Reserve from 1913 was carried forward in the new 1935 Banking Act.[23]

The fight in Congress

The passage of the Banking Act was by no means assured, as Roosevelt had warned. Senator Glass was in a foul mood after Eccles had failed to provide him with an advance copy of the bill. A former Treasury secretary under Woodrow Wilson, Glass was the "father" of the Federal Reserve Act of 1913 and the most senior member of the Senate Banking and Currency Committee. He did not look favourably on Eccles' attempt to reform the Federal Reserve and intended to ensure that the bill would not pass. He enlisted the aid of the large banks in this fight, since most of them were also sceptical of the bill. They feared too much political control of the Federal Reserve, too much deficit financing, and the loss of private control of open market operations.

Winthrop W. Aldrich, the chairman of the board of Chase National Bank in New York, expressed the fear many bankers felt when he noted that the Administration could use the System "for the purpose of creating a boom at the time when an election approaches" and the Treasury could use " . . . the Reserve banks as a means of finance" (Weldin 2000, p. 65).[24]

The bankers' resistance to the bill confirmed Eccles' concern that they could block any attempts by the Administration to undertake large-scale public works. It was his view that the Federal Reserve would have to absorb a large part of the bonds needed to finance such works, but with private banks in control of the regional Federal Reserve banks, this source of financing could easily be blocked (Hyman 1976, p. 165). This made passage of the bill all the more urgent for him.

After the initial hearing of the bill in the House, it became evident that passage there would be easier than in the Senate. Senator Glass was delaying Eccles' hearing before the Banking and Currency Committee for days, producing all sorts of excuses. When Eccles finally appeared, he tried to downplay the radical nature of the bill, stressing that "there is nothing in this bill that would increase the powers of a political administration over the

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[23] After the Second World War, Eccles again tried to persuade Congress to institute a more specific objective when the Employment Act was enacted in 1946. But Congress compromised on a vague formulation that all government agencies should endeavour to secure "maximum employment, production and purchasing power" and no changes were made to the Federal Reserve objectives at that time either (Meltzer 2003, pp. 611-12).

[24] He was the son of Senator Nelson Aldrich (1841–1915), who was one of the main architects of the 1913 Federal Reserve Act.

Reserve Board" (US Congress 1935, p. 280). But, he noted, the bill would strengthen "the public control of the function of supplying the medium of exchange to the people of the United States, both by issuing currency and by regulating the volume of bank deposits." Eccles noted that this would surely not be a controversial matter.

> It is in direct recognition of the constitutional requirement that Congress shall coin money and regulate the value thereof. In delegating this power Congress has chosen, and, in my opinion, always will choose, to delegate it, not to private interests but to a Government body like the Federal Reserve Board, created by Congress to serve as its own agency in discharging its responsibility for monetary control. (*Ibid*., p. 281)

But he also noted that "the Federal Reserve could not work at cross-purposes with the Government, particularly at times of emergency. Since central banking institutions derive their power from the Government—are, in fact, creatures of the Government—there must be cooperation between the Government, which determines economic policies, and the bank of issue which determines monetary policies" (*Ibid*., p. 284).

In the House of Representatives, the bill was pushed through aggressively with the help of Representatives Steagall and Goldsborough, and passed on 9 May by a vote of 271 to 110.[25] In the Senate, however, Senator Glass continued his delaying tactics.[26] As the 1 July deadline approached with no compromise in sight, the banking industry increased its pressure to drop Title II from the bill. Senator Glass suggested that Title II could be sent back to committee for further study, but Eccles noted that "these differences of opinions represent fundamental differences of approach to economic problems" that could not be resolved by further committee work (Eccles 1951, p. 216). After direct intervention by Roosevelt, the Senate finally passed its version of the bill in overtime, on 2 July. According to Eccles, "it was woefully inadequate and a world apart from the aggressive version that had passed the House of Representatives" almost two months earlier (*Ibid*., p. 219), but still better than nothing.

When the House and Senate converged to flesh out the final bill in conference proceedings, Eccles worked closely with Goldsborough to secure passage of the most substantive parts of the bill. He advised Goldsborough to give in on matters of less

[25] Eccles notes that: "It was no exaggeration to say that had it not been for Steagall and Goldsborough, the whole attempt to revitalize the Reserve system should have been killed off by the very men who first gave it life" (Eccles 1951, p. 181).
[26] Glass had tried in vain to block the appointment of Eccles as Federal Reserve chairman. He almost succeeded, but some last minute chance encounters shifted opinion among some members of the committee, and Eccles was confirmed on 25 April (Eccles 1951, p. 204).

importance, while making sure the five basic provisions of the House bill prevailed. In this way Senator Glass was left with the impression that he had won the legislative battle, although “he did not realize that the fewer points on which Goldsborough had his way had a combined importance that was at least equal to the sum of Glass’s individual gains” (*Ibid.*, p. 221).

When Roosevelt finally signed the Banking Act of 1935, the press portrayed it as “Senator Glass Wins Victory,” and the senator himself gloated by saying, "We did not leave enough of the Eccles bill with which to light a cigarette" (Phillips 1995, p. 127). But Eccles was satisfied with the new Act and noted that the Federal Reserve Board now was in firm and formal control of monetary policy, including the setting of reserve requirements and the formulation of open market policies.[27]

WAR FINANCING AND INFLATION FEARS

In September 1938, the presidents of the Federal Reserve banks met to consider options for wartime policy. They agreed that it was important to stabilise government securities markets, to avoid the problem of rising interest rates as investors deferred purchases of bonds in anticipation of even higher rates (Eichengreen and Garber 1991, p. 180). And early the following year, the Federal Open Market Committee (FOMC) was authorised to buy government securities to prevent their prices from falling (= yields from rising). This was a continuation of the low interest rate policy of the 1930s, but now in a more formalised manner.

The Treasury wanted low interest rates to support the sale of war bonds. Treasury Secretary Morgenthau’s goal was to finance at least 50 percent of the cost of the war by direct taxes and the rest by voluntary purchases of bonds, at the lowest possible rates (Meltzer 2003, p. 588). The final result was closer to 40 percent tax financing and a large part of the bonds held by banks.[28] This low share of nonbank absorption of government securities was to become a constant source of friction between the Treasury and the Federal Reserve during the war, and would serve as the prelude to the fight over interest rates that eventually led to the 1951 Accord.

[27] Under the final version passed by Congress, the previous practice of representation on the Federal Reserve Board by the Treasury and FDIC was discontinued. This surely strengthened the Board’s independence.
[28] Keynes advocated a compulsory saving scheme to finance the war in the UK. Morgenthau argued that this was not required in the US since there was still unused capacity in the economy (Meltzer 2003, p. 588n8).

War financing: the peg

After the US had entered the war, the Federal Reserve System agreed in March 1942 to fix the rates on government securities at 3/8 percent for Treasury Bills and 2½ percent for long bonds. The long-term rate would remain at this level up until the Accord in March 1951. Federal Reserve banks offered to purchase all securities offered to them at these prices to prevent interest rate increases.[29][30]

Although the agreed yield curve was an accurate reflection of the market at the time, soon afterwards, the newly "guaranteed" rates prompted a massive rebalancing of private portfolios from short- to long-term securities. Investors sold bills for higher yielding bonds, forcing the Federal Reserve to do the converse. By the end of the war, the Federal Reserve System held virtually the entire supply of Treasury bills (Eichengreen and Garber 1991, p. 181); "Bills ceased to be a market instrument" (Eccles 1951, p. 359).

Banks would offer their customers cheap financing to purchase bonds during the Treasury's campaigns, only to buy back these bonds afterwards. The Treasury officially opposed this policy, yet did little to prevent it. As a result, nonbank purchases during the war amounted to some USD 147bn, but since a large proportion of these were sold back to the banks, the nonbank sector was left with a balance of only USD 93bn by the end of the war (Meltzer 2003, p. 591). And as Meltzer noted (*Ibid*., p. 598), "the result of the war financing was very different from the founders [of the Federal Reserve's] plan; the System had [by then] become an indirect source of government finance". It would soon become a direct source as well.

In March 1942, the Second War Powers Act authorised Federal Reserve banks to purchase US securities directly from the Treasury. Eccles informed the Board about this decision after a meeting with President Roosevelt. As a result, Section 14(b) of the Federal Reserve Act needed to be amended.[31] Eccles added, however, that "the use of the new power would arise only in exceptional circumstances as, for instance, in a situation where a

[29] According to Meltzer (2003, 594), the Treasury was not initially interested in an explicit peg. They asked the Federal Reserve System to keep large reserves in the market, preferably by reducing reserve requirements. When the Federal Reserve objected, the Treasury then proposed the 3/8 percent rate. The Federal Reserve concurred in March to support "the pattern of (low) interest rates" and "the general market to be maintained on about the present curve of rates."

[30] Eichengreen and Garber (1991, 180n8) argue that there was only an informal agreement on the bond rate of 2½ percent, although there was no convincing explanation of the decision to settle on just that rate. Britain had pegged consols at 3 percent, and US officials argued that superior US credit justified a lower rate. Eccles and the Board thought the rate had been set too low (Hyman 1976, p. 283).

[31] Section 14(b) of the Federal Reserve Act contained a prohibition against the purchase by Federal Reserve banks of direct and guaranteed obligations of the US other than in the open market (BGFRS 1942, p. 2).

Treasury issue temporarily could not be sold and the Treasury was in need of funds, in which case the Federal Reserve banks would take the issue and resell it to the market" (Board of Governors of the Federal Reserve System (BGFRS) 1942, p. 3).

Whereas Eccles downplayed the decision as "merely a change in the method of distribution", Alan Sproul of the New York Federal Reserve opposed the proposal. He considered the change to be "somewhat revolutionary" since it would transform the Federal Reserve System into a distributing agent for government securities. "This method of operation might have inflationary effects and could cause the public to lose confidence in US securities" (*Ibid*., 6). Sproul was, however, the only dissenting voice and the policy change was adopted.

At the end of the meeting, Eccles noted that exceptional times required exceptional actions. Any attempt by the Federal Reserve to assert its independence and oppose the new policy "would result in the loss of authority and influence that it otherwise might have". It would be a mistake for the central bank to regard itself as being completely independent, and "the kind of independence a central bank should have was an opportunity to express its views in connection with the determination of policy, and that after it had been heard it should not try to make its will prevail, but should cooperate in carrying out the program agreed upon by the Government" (*Ibid*., p.8). His cautious interpretation of central bank independence must have been influenced by the war situation, and his views would gradually change as post-war inflation became a more imminent threat.

The change in operating procedures was indeed revolutionary, and was not merely a technical change, as Eccles suggested.[32] The new policy would remain in place long after the war had ended. The War Powers Act was set to expire after the war ended, but the Board requested renewal for two more years; later, this authority became permanent (Meltzer 2003, p. 599). The change permitted the Treasury to continue to borrow limited amounts directly from the Federal Reserve. Beginning in 1979, restrictions were placed on the terms of such loans, and certain conditions related to the use of the facility were imposed. In 1981, the authority to make such direct loans to the Treasury was rescinded permanently (Meulendyke 1989, p. 152n2).

[32] Indeed, the question of direct purchases of government paper goes to the heart of the current debate in the euro area of how to resolve the ongoing financial crisis.

Eccles's inflation fears

Early concerns

Eccles had been concerned about inflation long before the war. He strongly adhered to the view that there needed to be a balance between the quantity of money and the availability of goods. As much as he favoured deficit financing in the 1930s, he advocated balance budgets "in time of high business activity" and noted with regret that "many of those who in the depression years talked the loudest about inflationary dangers are the most reluctant to do anything about it now" (Eccles 1951, p. 346). And as the months passed and wartime expenditures continued to accelerate he "lived in great concern lest the dam that held back the inflationary pressure should give away" (Eccles 1951, p. 404).

For Eccles, inflation was not just a matter of economic policy, it was also a matter of justice. "It injures most the aged, the pensioners, the widows, and the disabled, the most helpless members of our society. It diminishes the desire to work, to save, and to plan for the future. It causes unrest and dissension among people and thereby weakens our productivity and hence our defence effort. It imperils the existence of the very system that all of our efforts are designed to protect" (Eccles 1951a, p. 2).

Eccles' pressure on the Treasury to raise taxes to pay for the war was therefore fully in line with the principle of compensatory policy. According to Eccles, this "implies a willingness to run counter to private business behavior not only in the downswing but also in the upswing" (Eccles 1937, p. 14). This was a position he had flagged already during the Depression: "There can be, I think, no question of our ability to prevent recovery from becoming inflation, and I assure you that there is no question of the Administration's desire to promote stability once recovery has been fully secured" (Eccles 1935b, p. 16).[33]

Monetary policy locked to the peg

The agreement between the Treasury and the Federal Reserve to support the low interest rate policy of the Administration had the unintended consequence of greatly increasing bank reserves. Eccles noted with regret that "the potential credit which the banking system can extend today is almost without limit" (Eccles 1951a, p. 12):

[33] In a comment on a US Congress report, James Tobin stated the same view: A fiscal surplus should be used when inflation threatens, <u>and only then</u>, whether the national debt is zero or USD 300bn (Tobin 1950, p. 557, emphasis added).

> The banking system nullified and completely offset the effect of the anti-inflationary action of the government's [tight] fiscal policy. The banking system expanded bank credit and investments, other than government bonds, by an amount equal to the debt the Federal government paid off. The banks, in other words, created an amount of money just about as fast as the Federal Government, through its fiscal policy, contracted the money supply. (Eccles 1948b, 8)

But Eccles was reluctant to move against the Treasury. He noted that the Federal Reserve had "adequate powers to stop a further bank credit inflation right in its tracks, but to do so they would have had to withdraw support for the Government market" (Eccles 1948b, p. 12). And the Board was also concerned about the impact on the bond market and on financial stability more broadly if it were to increase its discount rate:[34]

> Certainly if we should do what some people ask us to do, that is, use the traditional authority of the Federal Reserve System, withdraw from the Government bond market, let interest rates go up as the means of stopping credit expansion, let them go so high that people just won't borrow, or let them go so high that you certainly would stop inflation—where would the cost of carrying the public debt go if you pursued that policy? (*Ibid*., p. 16)

He noted that around sixty percent of the public debt (of USD 250bn) was held by the banking system and that an increase in the long rate would have a negative impact on banks' balance sheets. Thus, "the debt must be managed and the long term rate [the 2½ percent rate] must be protected" (*Ibid*., p. 12). An increase in rates would also raise bank earnings, which were already very high, and would further act as a disincentive for banks to lend to the private sector (Eccles 1946, p. 2). Therefore, Eccles concluded that, "to raise the discount rate was purely academic and would not be effective anyway" (Eccles 1948b, p. 13).[35]

Eccles also favoured maintaining cordial relations with Treasury Secretary Morgenthau, although during the war this proved difficult. There were numerous skirmishes between them, as the Treasury was insistent on selling bonds at low rates to finance the war effort, and the Federal Reserve was increasingly concerned with the extent of to which financing was actually being done by banks.[36] Their relationship continued to be coloured by the situation in the 1930s when the Federal Reserve's ability to conduct market operations had been constrained by its small holdings of government securities and the Treasury had

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[34] Many of the key policymakers at the time still had vivid memories of the sharp fall in government bond prices after the First World War, when a sharp increase in rates to protect the dollar had wiped out over 20 percent of the bond market.
[35] He added that as long as the Federal Reserve supported the bond market, it provided money for the banks to lend. "Under these circumstances to raise the discount rate is meaningless" (Eccles 1948b, p. 13).
[36] See Hyman (1976, p. 293n30) for more details.

threatened to use its Exchange Stabilization Fund and other Treasury accounts to bring the Federal Reserve into line with its policy wishes (Meltzer 2003, p. 484, p. 634). During the war, Treasury officials would frequently call on Federal Reserve Board members to remind them of their commitment (to the war financing effort) and check on progress (Hyman 1976, p. 284). And then there was Roosevelt's directive to his Cabinet (dated 15 July 1943) to sort out policy differences without going public and especially without involving the press (*Ibid*., p. 300). Eccles respected the President's "ban against public controversy within the administration", but relations with the Treasury remained tense (*Ibid*., p. 305). The Treasury preferred low rates, while the Federal Reserve wanted more flexibility. Thus, the two parties were deadlocked over any changes in interest rates.

The Federal Reserve is reluctant to act

Hamstrung and unable to use its primary policy instruments, the Federal Reserve pressed Congress for supplementary powers. It repeated these demands in its annual reports in 1946, 1947, and 1948 without prompting a reaction from Congress or winning the Administration's approval (Eccles 1951, p. 426). Thus, whereas Eccles desired to re-establish the Federal Reserve's core monetary function (Eccles 1946, p. 14), he also remained committed to protecting the long-term rate of 2½ percent.[37] As a result, the Federal Reserve ended up monetising all the debt that others were unwilling to hold at the given yield pattern (Chandler 1949, p. 419).

The Board then looked for other ways to restrict credit. In January 1946, it decided to increase margin requirements to 100 percent in an effort to curb speculative trading on Wall Street and continued to explore other administrative measures such as special reserve requirements, loan reserves, and even voluntary guidelines.[38] Nevertheless, Eccles recognised that voluntary restraint would have little effect and continued to press Congress for supplementary powers.

In retrospect, Eccles "regretted that the Board did not take a more independent position [during this period] despite Treasury resistance. There was no justification for our continued support of the Treasury's wartime cheap-money policy" (Eccles 1951, p. 425). Even so, Eccles's position at the time was not unique. It was a widespread view that

[37] "The one thing you cannot do is to have confidence shaken in that 2 ½ percent rate. If you let that go below par, there is always a question, where does it go? Because people remember, a great many of them, what happened after the last war when they let those securities go below par" (Eccles 1947, p. 620).

[38] Eccles agreed that the effect on inflation of increasing the margin requirement would be minor and suggested that the speculative activity could better be addressed by an adequate capital gains tax (BGFRS 1946, p. 2).

monetary policy should support the Administration's budgetary policy, and fiscal policy was believed to have a much more powerful effect on prices and economic activity than changes in the money supply or the interest rate (Meltzer 2003, p. 581).[39]

As Eccles told Congress in 1947: "We doubt whether a reasonable rise in short-term interest rates under present conditions of business profitability would deter borrowers. We do not believe it would effectively deter lenders" (Eccles 1947, p. 8). He went even further in a letter to Treasury Secretary Snyder in April 1946, noting that "we wish to emphasize with all the force we can command that our purpose and policy are based not on a desire for a higher level of interest rates … but entirely on grounds of discouraging further needless monetization of the debt" (quoted in Eccles 1949b, p. 11).

Inflationary pressures

When the war ended, Congress wanted to remove all wartime wage and price controls immediately. The Administration was hesitant and extended some of the controls, but finally relented. To balance the price impact, they tightened the budget, but this effect was nullified by strong credit growth by the banking system. The result was strong inflationary pressures; US wholesale prices rose by 25 percent on an annual basis (Eichengreen and Garber 1991, p. 183).

Eccles noted that despite balanced budgets, the money supply was increasing faster than goods became available: "the money supply remains excessive in relation to total production" (Eccles 1948a, p.3). He and the Federal Reserve Board opposed the termination of price and wage controls, and also the premature repeal of the excess profits tax in 1945 (Meltzer 2003, p. 608). Eccles argued that "when the war is over, it should be apparent to everyone that the need of controls is much greater, if anything, than during the war" (Eccles 1948b, p. 5). He felt that the government did not appreciate the seriousness of "the inflation problem". It would have been much better to retain the controls and delay tax reductions "until such time as supply was more nearly in balance with demand" (Eccles 1951, p. 411). The net result of removing "all the essential harness of controls" was more inflation after the war than during the war: "The real inflation was not from 1940 to 1945; the real inflation came within the past two years with the taking off of the controls prematurely" (Eccles 1948b, p. 7).

[39] Meltzer notes that "this belief in the impotence of monetary policy was so widely held that it was hard to find any memo suggesting the opposite" (Meltzer 2003, p. 634).

Eccles raised the issue several times with Treasury Secretary Vinson, but the response was always the same: "The proposal would increase the already large interest charge on the public debt" (Eccles 1951, p. 423). Eccles explained that the Federal Reserve had a mandate from Congress to control inflation, and that the current policy of pegged rates added to inflationary pressures. But the Treasury was sold on "the philosophy of low and lower rates of interest; that low rates have little effect on inflation, and that inflation has to be dealt with by direct, rather than monetary measures" (Eccles 1949b, p. 5). The Treasury accused the Federal Reserve of "staging a sit-down strike by refusing to carry out Treasury policy," while Eccles noted that "if we carried out Treasury policy we would default on our obligations to Congress in the field of money and credit" (Eccles 1951, p. 424).

As a result, interest rates remained low, prices continued to rise, and finally President Truman called a special session of Congress (in autumn 1947) to restore wage and price controls. Congress did not approve of his proposals, but instead authorised the Federal Reserve to control consumer credit and instalment loans in an attempt to curb the very rapid growth in credit from the banking sector.

Then, in 1948, a brief recession led to a brief respite from inflation. Wholesale prices stopped rising and industrial production levelled off. As demand for loans softened, banks and insurance companies once again began to purchase Treasury bonds (Eichengreen and Garber 1991, p. 184). The Federal Reserve Board regarded the recession as temporary, and also as a welcome interlude in its fight against inflation. It therefore tried to prevent interest rates from falling during the recession by selling bonds. The Federal Reserve even considered raising reserve requirements (Eccles 1948a, p. 4; Meltzer 2003, p. 668). The Federal Reserve's action was widely criticised for aggravating the recession (Eichengreen and Graber 1991, p. 184). It also showed how difficult it was for the Board to transcend the policy agenda of the past.[40]

By early 1950, industrial production had recovered and consumer prices began to rise again. The resurgence of inflationary pressures resulted in renewed bond purchases by the Federal Reserve System. The Board continued to press for slightly higher rates, but the Treasury continued to resist. By this time, however, the budgetary situation added to the worries of the FOMC. After three years of surpluses, the 1950 budget showed a deficit. With defence and foreign aid spending on the rise, there appeared to be less scope for reduction in

[40] However, the Board did reduce reserve requirements in several successive moves during the second quarter of 1949. Chairman McCabe noted that this proved the inherent "flexibility of the structure and organization of the Federal Reserve System" (McCabe 1949, p. 495).

the monetary base (Meltzer 2003, p. 680). The Treasury was again issuing new securities to finance the deficit and permitted only very modest increases in short-term rates. The long-term rate remained between 2.38 and 2.43 percent for the entire year.

The return of expansion and inflation led Alan Sproul of the New York Federal Reserve to press for a firmer Board policy, to send “a signal to the whole financial community and to the public that there has been a change in our policy in light of the changed business and credit situation” (Meltzer 2003, p. 682). He was willing to confront the Treasury, by increasing the short rates and, if need be, letting long-term bonds fall below par (i.e. allow their yields to rise above 2.5 percent). Eccles gave Sproul limited support. He did not think the market was sufficiently flexible yet to permit wider fluctuations in long-term bond prices. And other members feared that “a large Treasury issue under these conditions might set off an over-rapid readjustment in the corporate bond market with undesirable effects on business psychology” (BGFRS 1950a, p. 7). The issue remained unresolved, as Treasury Secretary Snyder refused to raise the offering rates on the new issues. As the Fed was not prepared to let the new issues fail, it purchased heavily, offsetting part of its purchases with sales of bills. “So in this way the first real skirmish between the Fed and the Treasury ended with the System supporting the rates set by the Treasury” (Meltzer 2003, p. 683).

THE 1951 TREASURY–FEDERAL RESERVE ACCORD

Dramatis personae

Eccles started his Washington career as an assistant to the newly appointed Treasury Secretary, Henry Morgenthau, Jr. Morgenthau was a firm believer in balanced budgets, which would remain a constant source of discordance between the two men. Eccles was also a strong-willed person with independent views on fiscal policy, which he would air directly with the President. This certainly did not improve relations between the Federal Reserve and the Treasury. And tensions remained, even after Morgenthau was replaced by Secretary Snyder, which indicated that there might be deeper structural reasons for the constant friction between the two agencies. Eventually Eccles fell out with the Truman Administration and was replaced as chairman by Thomas McCabe.[41] Tensions continued to build all the way up to the 1951 Accord. Then, surprisingly McCabe was fired and the

[41] Eccles remained on the Board as an ordinary member, and continued to have a strong influence on monetary policy, together with President Sproul of the New York Federal Reserve.

Assistant Secretary of Treasury McChesney Martin, who had negotiated the Accord with the Federal Reserve, was appointed chairman. He would go on to become the longest serving chairman in the Federal Reserve's history and defend its newly gained independence.

To better understand the institutional rivalry between the Treasury and the Federal Reserve before the Accord, a short note on the key persons involved is appropriate.

Morgenthau and Eccles

Henry Morgenthau, Jr. (1934–1945) was appointed Treasury Secretary by his good friend the President in 1934. Despite his friendship with Roosevelt, Morgenthau was an orthodox economist who opposed Keynesian economics and disapproved strongly of deficit financing. He appointed Eccles Chairman of the Federal Reserve Board of Governors in 1934, but would go on to fight Eccles for control of credit and monetary policy for the remainder of his term. While Eccles favoured compensatory financing, Morgenthau appealed to Roosevelt's desire for a balanced budget. Morgenthau resigned in 1945.

Marriner S. Eccles (1934–1951) started his Washington career as an assistant to Morgenthau in 1934. His first major task was to design the new National Housing Act, which was intended to revitalise the construction industry. When he was appointed Federal Reserve chairman, Eccles immediately set out to reform the Federal Reserve System. He also pressed Roosevelt to embrace deficit financing as a cure for the unemployment problem, but succeeded only with the advent of war. Eccles was considered both a "crank" and a "crusader" with little regard for the subtleties of Washington politics. He would frequently clash with bankers and politicians alike, and would also stubbornly persist in raising unpopular issues (like the need to unify the fragmented system of US banking supervision). He was not reappointed in 1948. While President Truman gave no reason for removing Eccles as chairman (Meltzer 2003, p. 656), Eccles suspected that his investigation of Bank of America was a contributing factor.[42] Eccles went on to serve as an ordinary Board member until his resignation in 1951, shortly after the Accord had been agreed upon.

Snyder and McCabe

John W. Snyder (1946–1953) was appointed secretary to the Treasury in 1946, when Fred Vinson left the Treasury to become chief justice of the Supreme Court. Snyder was an old

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[42] See Weldin (2000): "A.P. Giannini, Marriner S. Eccles, and the Changing Landscape of American Banking," for the full story on this fascinating chapter of American banking history.

friend of Truman's. During the war, he served as executive vice president of the Defense Plant Corporation, a subsidiary of the Reconstruction Finance Corporation (RFC). When Truman became president, Snyder advanced rapidly in Washington. His appointment as Treasury secretary was described by some as "government by crony" and by others as "an uninspiring choice, one that seemed to be made too hurriedly by Truman". The press described him as a "dour little St. Louis banker" (Weldin 2000, p. 148). Snyder's approach to fiscal policy hardly varied from Morgenthau's. He insisted that the Federal Reserve back government securities at fixed prices. Meltzer (2003, p. 635) notes that "Snyder knew very little about monetary and fiscal policies." Thus, Treasury staff would carry forward the conservative budget polices from Morgenthau and generally push for an "easy money policy."

Eccles later recalled in his memoirs the close connections between the Truman Administration, and Snyder in particular, and Transamerica (later Bank of America). He noted that one of Snyder's close associates, Sam Husbands, who had been a director of the RFC during the war, later accepted "a high position at a flattering salary with the Transamerica interests" (Eccles 1951, p. 448) and that another close associate and former council for the Truman election committee went on to become the general counsel for Bank of America (*Ibid.*). These connections certainly had some influence on the Administration's decision not to reappoint Eccles, although Eccles was careful not to draw any explicit conclusions.

Thomas B. McCabe (1948–1951) had been a board member and chairman of the Philadelphia Federal Reserve before he was appointed chairman of the Federal Reserve Board on 15 April 1948, when President Truman removed Eccles as chairman. During the Second World War, McCabe was the head of the Advisory Commission to the Council of National Defense, the same organisation in which John Snyder served as executive vice-president. He was also chairman of the board of the Scott Paper Company, which, during his chairmanship, grew from a small mill into a multinational company with production facilities throughout the world. He served as Federal Reserve chairman until 31 March 1951, when Truman asked him to resign (Meltzer 2003, p. 656). Treasury Secretary Snyder recalled that Truman believed the appointment of McCabe was a mistake: "Truman, while discussing the demotion of Eccles and appointment of McCabe, admitted that 'I got one just as bad anyway'" (Weldin 2000, p. 212). Leach recalls, however, that "McCabe made the Accord possible through the professional, honest way that he presented the case for monetary independence to the executive branch and Congress" (Hetzel and Leach 2001, p. 37n9).

Martin and Sproul

William McChesney Martin, Jr. was appointed the new chairman of the Federal Reserve Board when McCabe resigned, just six days after the Accord statement was released. As assistant secretary for monetary affairs at Treasury, Martin was a key architect of the Accord. Ironically, Truman's attempts to curb the power of the Federal Reserve chairman by appointing William McChesney Martin backfired, for Martin proved to be a strong and independent chairman who served for almost nineteen years. Martin was able to pursue relatively independent monetary policies without clashing with various administrations. He noted (Martin 1952, p. 4) that "The Federal Reserve must do everything in its power to see that the Treasury is successfully financed, but neither the Treasury nor the Federal Reserve should succumb to the temptation to ignore the judgments of the market through our price mechanism in arriving at financial decisions." Martin is perhaps best known for his phrase "It is the job of the Federal Reserve to take away the punch bowl just as the party gets going" (Goodhart 2009, p. 12).

Allan Sproul should also be mentioned, as he played a key role in the creation of the Accord. He was an influential force during his long association with the Federal Reserve System. He began his service in the research area of the San Francisco Fed in the 1920s and ended up serving as president of the New York Federal Reserve. He was the manager of open market operations there for many years before becoming president in 1941. He is considered "one of the giants of central banking" (Hetzel and Leach 2001, p. 35n7) and made major contributions to monetary policy and theory. Sproul was an early spokesman for a more independent monetary policy and usually pushed ahead of Eccles in meetings with Treasury Secretary Snyder. As the senior members of the Federal Open Market Committee, he and Eccles were the dominant force on the committee. Sproul gained more influence on Board policies when McCabe became chairman (Meltzer 2003, p. 582). Sproul resigned in 1956 and returned to California to serve as a director of Wells Fargo Bank.

Structural or personal differences?

The persons involved in the events leading up to the Accord made a difference. Their points of view and personalities influenced the dialogue and interacted with the underlying structural undercurrents to make the Accord possible. As the conflict escalated between the Treasury and the Federal Reserve, they all played their different roles, but in different positions; Treasury Secretary Snyder and Chairman McCabe locked into diametrically opposite positions, with Allan Sproul cheering from the sidelines in New York, Eccles working in the background, and Martin emerging as the mediator who was able to square the circle and get the parties to agree.

When Eccles' term as chairman expired without a presidential renewal, most observers expected him to step down.[43] He decided to continue on the Board as a regular member and would continue to play an important role there together with Sproul. But his demotion triggered so much media attention that the Senate held a separate hearing to probe the reasons for his "downfall." Despite reports about Snyder's and Eccles's battles, Snyder denied the allegation: "To my knowledge, Mr. Eccles and I have never had any scrap or argument … and I think he will tell you the same thing" (Weldin 2000, p. 165). Snyder would take the same position during the Douglas hearings, when he noted that "I have been very happy with the cooperation of the Federal Reserve. I think it has been splendid" (US Congress 1949, p. 408). Others observed that style and personality mattered; Eccles had become unpopular with the banking community "because he is unorthodox: when a man like Eccles comes along and urges unorthodox methods, they get annoyed." Another article described Eccles as "stepping out of character" by holding positions contrary to the administrations and his "inordinate desire for power" (Weldin 2000, p. 165).

Eccles reflected on these issues in his memoirs and concluded that "the difficulties that arose between the Treasury and the Federal Reserve were not due to a clash of personalities":

> They were due to a conflict of responsibilities. The Treasury's primary job is to finance the government at the lowest cost at which it can induce the public to buy and hold government securities over a long period. As an independent agency responsible to Congress, the Federal Reserve has the job of regulating money and credit in such a manner as to help economic stability. Theoretically there should be no clash between these two objectives, but one did arise after the war over the continuance of the cheap-money policy of the wartime period of heavy deficit financing. This conflict has continued up to the present time and has intensified since the outbreak of the Korean War despite the existence of budgetary surpluses and increasing inflationary pressures. (Eccles 1951, p. 420)

Board member Sienkiewicz was less charitable. He described the Treasury as under the control of its staff. "Mr. Snyder did not really know very much about the problem he should have been coping with" (Meltzer 2003, p. 635n94). And Eccles made the additional observation about the difficulties of the entrenched views of old Treasury staff when he

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[43] Ironically, Eccles noted during the Congressional hearings on the 1935 Banking Act that "You know, gentlemen, as well as I do that no man would stay on the Board if the President of the United States wished to appoint someone else in his place" (US Congress 1935, p. 282).

notes that “our position vis-à-vis Treasury policies did materially improve when Lee Wiggin became undersecretary for the management of public debt. The Treasury staff did not shape his opinions; he was well able to shape his own” (Eccles 1951, p. 425). Thus, personalities influenced the relationship between the two agencies, both at the staff level and at the executive level.[44]

Chairman McCabe touched upon the same issues in his testimony before the Douglas committee, when he noted, “there have always been differences between the central banks and the treasuries.” Senator Douglas’s view was that “these conflicts of opinions are inevitable and irrespective of personalities, because each body is lodged with a different duty” (US Congress 1949, 491). It was therefore essential for Douglas that the Federal Reserve System should be given an explicit mandate—“a norm of action”—that could minimise these conflicts in the future. Such an objective would serve as “a benchmark for judging their performance” and enable the Treasury and the System to respect each other’s domains. He felt that “… the Treasury and the System will be better neighbors in the long run, the less they invite themselves in to play in each other’s backyards. The proper principle is, ‘Good fences make good neighbors!’” (US Congress 1952b, p. 76).

Douglas’s idea of a clear mandate for the Federal Reserve echoed Eccles’s attempt in the mid-30s to get Congress to include such an objective in the 1935 Banking Act. But even though Douglas’s attempt to insert a new objective in the Federal Reserve Act did not succeed, his report prepared the way for the Accord agreement that would soon put the new fence posts in place.

The battle of the peg

The Treasury–Federal Reserve debate over monetary policy was characterised as “a violent conflict” (Sproul in BGFRS 1951a, p. 9), “a struggle” (Tobin 1950, p. 118), “a confrontation” (Hetzel and Leach 2001, p. 4), “a war” (Timberlake 1999, p. 6), and “a dispute” (Eccles 1951b, p. 1). Sproul later dismissed the association with “a battle that the Federal Reserve won,” since “the System may have won a battle, but Governments always win the wars” (US

[44] Herbert Stein made an interesting observation on this issue during the Patman Committee hearings: “The most recent development in the Treasury-Federal Reserve relationship gives us the best lead. Mr. Martin is obviously respected and trusted by both the President and the Secretary of the Treasury. As long as he remains as Chairman, and retains their confidence, Federal Reserve will have great influence in the high councils. This is as it should be. The lesson is simple: The Chairman of the Federal Reserve Board should serve as Chairman at the pleasure of the President. This is the rule in most Federal commissions and it is peculiarly applicable here. It would also shorten the fear of fiscal dominance” (H. Stein, testimony in the Patman Inquiry, US congress 1952a, p. 760).

Congress 1952a, p. 535). He noted that there had been a “difference of opinion between the Treasury and the Federal Reserve System, both of them representing the Government, and you can call it a triumph of reason, if you want to, but not the winning of a battle” (*Ibid*.).

Internally, the Board would also play down the controversy, noting that “difference of opinion between the Treasury and the Federal Reserve over interest rates does not seem to be of epic dimensions” (BGFRS 1951b, p. 14). Even so, many still consider this event “the greatest political battle in the history of central banking” (Davis 2012) and the “battle of the peg” certainly has all the elements of a classical drama: the early skirmishes, the diversions, the parading, the attempts to win over public opinion, and the stubborn and strong-willed actors. Of particular interest is the evolution of views on monetary policy during this period among the key Federal Reserve actors, including Eccles, especially regarding the need for a more flexible interest policy.[45]

But as Meltzer notes: “The accord was not inevitable. The Truman Administration could have appealed to patriotism, to the exigencies of war and to populist sentiment against higher interest rates to keep the support program in place” (Meltzer 2003, p. 712). But four factors worked to the benefit of the Federal Reserve. First, it found support within the Administration. Second, the financial press took its side. Third, opinion in the Senate was shifting towards a more independent policy and inflation was rising rapidly (Meltzer 2003, p. 702). In the end, the Federal Reserve prevailed and a new era of central banking would begin (BGFRS 1951e, p. 12).

Early skirmishes

As the economy recovered from the 1948-49 recession, inflationary pressures were again building, and Eccles was repeating his calls for balanced budgets and monetary restraint. The Treasury remained unmoved by the repeated request for rate hikes. As President Sproul of the New York Federal Reserve would later say about this period: “We came over [to the Treasury] and laid down our programs with them time and time again, but the Secretary usually turned to an associate and then told us that he would let us know what he was going to do, but his announcements then differed almost completely from our recommendations”

[45] Eccles favoured fiscal policy to stabilize the economy and control inflation. But with inflationary pressures building after the onset of the Korean War and Congress reluctant to grant further administrative powers to control reserves, he gradually came to believe that a more flexible interest policy was required (Hetzel and Leach 2001, p. 37n8).

(BGFRS 1951a, p. 36). Patience at the Federal Reserve Board was about to run out, and over the next two years the two parties would be engaged in several early skirmishes.

Some rate flexibility

The recession in 1948-49 led to a potential radical change in the Fed's policies. By spring 1949, pressure was building for rate cuts to stimulate the economy, and in May, the FOMC decided to reduce the reserve requirement. The request to Congress for new powers to impose supplementary reserve requirements was temporarily put on hold. Since government securities no longer needed support, the FOMC issued a statement indicating the onset of a more flexible rate policy:

> With a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture … the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market at a time when the availability of credit should be increased. [Quoted in US Congress 1950, p. 24]

It was obviously easier for the Fed to gain acceptance from the Treasury for interest rate flexibility when the result was lower rates. But the announcement was nevertheless important, since it reflected a joint judgment of the Treasury and the FOMC that conditions were such that open market operations "could safely be permitted to play a more orthodox role in our policies" (McCabe 1949, p. 471). In his statement before the Douglas Committee, Chairman McCabe even considered the announcement "a significant milestone" as it "removed the strait-jacket in which monetary policy had been operating for nearly a decade; that is since the beginning of the war" (*Ibid.*, p. 471).

The statement did not spell out if the System was equally prepared to sell government securities if rates were rising. And as the Douglas report noted: "the Treasury might not have assented so readily had the policy been toward higher interest rates" (US Congress 1950, p. 24). At the time, some saw the statement as a sign that "the period of rigid support may have passed and that in the future Federal Reserve policy will be conducted with a view predominantly towards the regulation of credit conditions with reference to the business situation" (Goldenweiser 1950, p. 395). But as the Douglas report correctly noted "…the statement did not, and of course could not, indicate the extent of flexibility that will be employed in the future" (US Congress 1950, p. 24).

The Douglas Report

The ongoing Treasury–Federal Reserve tensions led Congress to appoint the Douglas Committee in 1949 to study the "Monetary, Credit, and Fiscal Policies" of the United States.

Senator Paul Douglas had been a professor of economics at University of Chicago and was elected to the US Senate in 1949 as a Democrat. As chair of the sub-committee he conducted the hearings during 1949 with considerable skill, and the report did its part in changing the political balance in Congress in favour of the Federal Reserve (Meltzer 2003, p. 582).

A key concern for the committee was the coordination between fiscal and monetary policies. As Senator Douglas noted:

> This is something that puzzles me a bit: As I remember it, the Federal Reserve System was supposed to be an independent agency; the Treasury, another independent agency. Yet, it is inevitable that the views of one be taken into consideration by the other, and highly desirable. What is the machinery for coordinating the policies of the Reserve System with the policies of the Treasury? (Quoted in Eccles 1949c, pp. 230-31)

Eccles gave only cautious support for central bank independence at this stage. The Federal Reserve should give advice to the Treasury and Congress, but "not enforce its will": "Any open-market committee, or any central banking system, that for any length of time did not go along with that conception (of independence) would not survive" (*Ibid*., p. 231). He noted that no other central bank "has ever successfully used its authority to enforce the will over any administration in power" (*Ibid*., p. 237).[46]

But he supported Senator Douglas's idea of instructing the Treasury in its debt management policies and its procedures of cooperation with the Fed (*Ibid*., p. 235). He also noted that the Treasury had a persistent (cheap) money bias, which made it hard for the Fed to raise rates. The Treasury did not see the need for rate increases, since they "continued to brush aside or depreciate the influence of interest rate changes on the availability of credit" (Eccles 1949b, p. 13).

In a supplementary letter to Senator Douglas, Eccles added that the size of the post-war government debt had complicated the conduct of monetary policy. As the size of the public debt grew, the needs of the Treasury for cheap financing became dominant. He also noted that when "the Treasury announces the issue of securities at a very low rate pattern during a period of credit expansion, … the Federal Reserve is forced to defend these terms unless the System is prepared to let the financing fail, which it could not very well do" (Eccles 1949a, p. 7). Under these conditions it could hardly be said that the Federal Reserve was in a position to independently set its own monetary policy.

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[46] Meltzer notes that Chairman William McChesney Martin, Jr. also shared this view during the 1950s and 1960s (Meltzer 2003, p. 689).

He therefore urged Congress to more directly define the respective roles of the Treasury and the Federal Reserve and “direct the Treasury to consult with the System in the formulation of its debt management decisions in order that these decisions may be compatible with the general framework of credit and monetary policy being followed by the System in the interest of general economic stability” (Eccles 1949a, p. 9; Eccles 1949b, p. 13).

Without such guidelines, the Federal Reserve System would be altogether subordinated to the Treasury (Eccles 1949b, p. 13).[47]

When Senator Douglas appeared on the Senate floor to defend the report, he observed initially that[48]

> [t]he so-called controversy between the Treasury and the Federal Reserve System must be utterly baffling to the general public. As a writer in Fortune Magazine put it, it seems like a battle between two adding machines. Yet, next to defense, it is by far the most important question we face today. (BGFRS 1951b, p. 1)

He noted that as long as the Federal Reserve remained “the residual buyer of Government securities,” every security the Federal Reserve buys adds to bank reserves, or “high-powered money” that would support further bank lending. “This is the royal road to inflation” (BGFRS 1951b, p. 10). The pegging of the rate structure should not be allowed to persist forever. Yet despite the strong positions taken by both agencies in the hearings, he sensed that there could be “a meeting of minds” (*Ibid*., p. 14). The Federal Reserve System needed to be freed from “support operations which continue week in and week out to feed high-powered dollars in the market where inflationary pressures are rampant and where bank loans alone have gone up by 10 billion dollars since Korea” (*Ibid*., p. 15). In order to avoid inflation, it was essential for the Federal Reserve to be able to restrict credit and raise interest rates “even if the cost should prove to be a significant increase in service charges on the Federal debt…” (*Ibid*., p. 16).

The report supported his views, and concluded that

> It is the will of Congress that the primary power and responsibility for regulating the supply, availability, and cost of credit in general shall be vested in the duly

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[47] While Eccles favoured “coordinated independence” for the Federal Reserve at the time of the hearing, he strongly opposed the idea of submerging the credit and monetary functions of the Federal Reserve in the Treasury, like “a division or a department of monetary and credit control”. “This may well lead, in time to a socialization of the credit structure, which, I think, would be very undesirable and very dangerous” (Eccles, 1949, pp. 237, 243).

[48] Senator Douglas had been provided with extensive notes from the Board of Governors before his Senate appearance: “Material furnished Senator Douglas by the Board on February 26, 1951. Used by Senator Douglas in his statement of 22 February on the Floor of the Senate” (BGFRS, 1951b, 20 pages).

> constituted authorities of the Federal Reserve System, and that Treasury action relative to money, credit, and transactions in the Federal debt shall be made consistent with the policies of the Federal Reserve. (US Congress 1950, p. 31)

This "Douglas resolution" asserted the primacy of the Federal Reserve Board in open market operations and credit policies, and directed the Treasury to adjust its debt management policies in the light of its policies (US Congress 1949, 390). Thus, the sub-committee supported the view that interest rates should be determined by monetary rather than by fiscal authorities (Goldenweiser 1950, p. 390).

The subcommittee's report helped shift public opinion towards the Fed's point of view. Even though the instructions and new mandates proposed by the committee were never passed, it probably stiffened the Federal Reserve's resolve in the subsequent conflict with the Treasury (Tobin 1953, p. 119).[49] Eccles also noted that congressional support during the hearings helped the Federal Reserve to regain its independence (Meltzer 2003, p. 685n184).

The Korean War

The other event that changed the Treasury–Federal Reserve balance that spring was the start of the Korean War (Meltzer 2003, p. 582). President Truman's attention was suddenly diverted when South Korea was invaded on 25 June 1950. The Korean Peninsula had been divided along the 38th parallel after the Japanese surrendered in September 1945, but failure to hold free elections in the North in 1948 led to tensions with the Soviet-supported communist regime. With the outbreak of war, there was an urgent need to switch US production from civilian to military use again. Expectations of shortages and possible rationing led to sharp price increases, and wholesale prices increased by 17 percent between June and December 1950 (Hyman 1976, p. 341). With upward pressures on interest rates as well, Federal Reserve purchases of Treasury securities continued at an accelerating pace.

Eccles had strong reservations about the war and feared that the US "was stumbling into an uncharted Asian morass without reckoning the costs" (Hyman 1976, p. 339).[50] He was also concerned that the US would "be weakened by a military program which we cannot maintain indefinitely without regimentation or inflation" (Eccles 1951a, p. 1). With the

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[49] Sproul observed during the Patman hearings in 1952 that …"the Accord was reached after it became clear that the Federal Reserve had a considerable support in the Congress and among the public for requesting and demanding equal powers and equal consideration in the determination of these questions of credit policy and debt management where they overlapped." US Congress, 1952a, p. 535)

[50] Eccles would later oppose the war in Vietnam on the basis of the same concerns.

government budget in rough balance, it was primarily the growth in private credit that needed to be reined in: “To prevent inflation we must stop the over-all growth in credit and the money supply whether for financing Government or private deficit spending. The supply of money must be controlled at the source of its creation, which is the banking system” (*Ibid*., p. 4). If required, interest rates should be allowed to go higher by withdrawing Federal Reserve support from the government securities market and penalising borrowing by member banks from the System. A continuation of the current policy of “frozen pattern of interest rates” would be highly problematic.

While Eccles denounced the Nationalist regime of Chiang Kai-Shek on Formosa (now Taiwan) and favoured recognizing the communist regime on the Chinese mainland, the war in Korea escalated. In autumn 1950, Chinese forces entered the war on the side of North Korea, and in January 1951, US forces were engaged in heavy fighting in and around Seoul. During this period, tension had been building between President Truman and General Douglas MacArthur. MacArthur opposed Truman’s policy of limited war and even wanted to use nuclear weapons if necessary. The dispute came to a head in mid-February, when MacArthur called Truman’s policies “unrealistic and illusory” (Hetzel and Leach 2001, p. 53).

The Korean War influenced Truman’s priorities; he could not fight two wars at the same time. He may have felt that the turf war between Treasury and the Federal Reserve was of lesser importance and left it to the two parties to sort out their differences. But it would still take some fighting before the final truce was signed.

The Fed flexes its muscles

In late 1950, the conflict between the Federal Reserve and the Treasury Department intensified and became public (Meltzer 2003, p. 699). With inflationary pressures mounting, the Federal Reserve Board was about to lose its patience with the Treasury’s foot-dragging.

The FOMC announces higher short-term rates

At the 18 August FOMC meeting, President Sproul of the New York Federal Reserve voiced his support for a more flexible rate policy and noted that the Treasury was unwilling to sop up available nonbank funds by issuing long-term securities. He stated that the discussion was not about the long-term bond rate or the refunding of September–October maturities, “but what we are going to do about making further reserve funds available to the banking system in a dangerously inflationary situation” (BGFRS 1950b, p. 10). He ruled out “drastic credit measures,” but added that they had “marched up the hill and then marched down again” too many times without convincing the Treasury of the need for rate changes. "This time I think we should act on the basis of our unwillingness to continue to supply reserves to the market by supporting the existing rate structure and we should advise the Treasury that this is what we intend to do, and not seek instructions" (*Ibid*., p. 11).

Eccles agreed with Sproul, and noted that he also felt "it was time the System, if it expected to survive as an agency with any independence whatsoever, should exercise some independence," particularly since the military expenditures was greater now and the budget deficit larger, adding to the money supply. He supported an increase in the discount rate, as well as increasing reserve requirements, to immobilise banks' reserves.

The same day, the Board announced an increase in the discount rate to 1¾ percent, and the FOMC allowed the short-term rate to rise to 1⅜percent. This was the first such change in two years. Furthermore, the Board noted that it was "prepared to use all the means at our command to restrain further expansion of bank credit" while "maintaining orderly conditions in the Government securities market" (BGFRS 1950b, p. 24).

After the meeting, Chairman McCabe and Sproul met with the Treasury Secretary and his staff and informed them of the rate increase. Snyder made no comment at the meeting, but announced immediately afterwards that the Treasury financing for September–October would take place at the old rate of 1¾. This was in direct conflict with the recent Fed announcement, and as a result, the Fed was forced to buy most of the new Treasury issue (Meltzer 2003, p. 693).

Meetings with Treasury

Later in the autumn, the FOMC met four more times without agreeing on further rate hikes. McCabe continued to seek a compromise with the Treasury Department, but the Treasury would not agree to any rate increase whatsoever. The inflation outlook was also more uncertain, and Snyder wanted more time to consult his staff. Sproul and Eccles pressed internally for higher rates, but agreed to wait for a response from the Treasury before going forward.

The lack of adequate response from the Treasury upset the Federal Reserve, as it became more resentful of continuing Treasury dominance. System officials were also sceptical about the Administration's policy to control wartime inflation. Sproul, in particular, thought the Administration's policy relied too much on ineffective quantitative control. He and McCabe met again with Snyder in early January 1951, and Sproul urged the

Administration to support higher rates so that the Treasury could sell debt without System support.

Sproul favoured long-term Treasury financing of the additional war expenditures at rates that would hold up in the market without Federal Reserve support. This suggested a slightly higher rate than the prevailing 2½ percent (BGFRS 1951, p. 6). And he noted that the next six months would be an appropriate period to change policy, as the Treasury would be largely out of the market. Only by offering a more attractive rate could the Treasury hope to obtain new money from long-term investors and not just switch outstanding securities into new Treasury offerings (*Ibid*.). Under normal conditions, a correctly priced long-term bond should attract new investment funds and be self-supporting in the market (*Ibid*., p. 8).

The Treasury Secretary listened attentively to what Sproul had to say, but did not reveal his own thinking on debt-management strategy or credit policy. When they left the meeting, Sproul and McCabe felt that this would be the beginning of a series of frequent consultations with the Treasury on rate policy. When technical discussions resumed the week after, Federal Reserve staff were therefore surprised to learn that Treasury staff had already prepared their proposals for Secretary Snyder without any consultations (*Ibid*., p. 8).

McCabe meets with the President and Snyder

Later, on January 17, Chairman McCabe met with the President and Secretary Snyder at the President's request. Truman's primary concern was to maintain the peg at 2½ percent. McCabe noted that their main problem was the surplus of restricted long-term bonds that carried a premium. The Fed added substantially to the reserves of the banking system through large-scale purchases of such bonds from insurance companies and savings banks, purchases, which at the time were highly inflationary as the demand for bank credit was exceptionally strong (*Ibid*., p. 12).

Snyder reiterated the Treasury's desire for a clear statement from the Federal Reserve on the 2½ percent rate, and noted that "the sooner we let the public know that the 2½ percent rate was going to be maintained, the better" (*Ibid*., p. 13). He noted that there was a lot of psychology involved and argued that investors would stop selling their bonds if the Fed would just reassure them that it would maintain the peg (Hetzel and Leach 2001, p. 42). Snyder was still upset by the unilateral actions by the Fed the previous autumn:

> If you [the Fed] had not jiggled the market the way you did a few months ago, you would not have had to absorb so many bonds from the insurance companies. I think that most of the securities you have been called upon to absorb have been the result of market uncertainty. (Quoted by McCabe in BGFRS 1951, p. 13)

The meeting ended inconclusively, but again, it was McCabe's understanding that a compromise was within reach. He was therefore surprised when he read in the newspapers the following the day that the Treasury Secretary had announced that the long-term peg would be maintained for the foreseeable future.

Snyder's speech in New York

McCabe was upset when he read the account of Snyder's speech in New York, especially since the Secretary had not even mentioned the speech in their meeting with the President the day before. Snyder's statement read as follows:

> In the firm belief that the 2½ percent long-term rate is fair and equitable … the Treasury Department has concluded, after joint conferences with the President and Chairman McCabe, that the refunding of new money issues will be financed within the pattern of that rate. (Quoted in Eccles 1951, p. 484)

Eccles noted that this was "an extraordinary event in the history of relations between the Treasury and the Federal Reserve" and he quoted New York Times journalist Edward H. Collins, who wrote:

> Last Thursday constituted the first occasion in history on which the head of the Exchequer of a great nation had either the effrontery or the ineptitude, or both, to deliver a public address in which he has so far usurped the function of the central bank as to tell the country what kind of monetary policy it was going to be subjected to. (Eccles 1951, pp. 484-85)

The announcement came as a particular shock to the Federal Reserve System. The Federal Reserve was under the impression that there was an ongoing dialogue with the Treasury on the design of the war financing programme. But officially, the Federal Reserve kept a low profile after Snyder's speech. An exception was Eccles, who appeared before Congress shortly after at the request of Senator Taft, a leading Republican on the Joint Committee on the Economic Report. The Truman Administration tried to prevent his appearance, and they wanted McCabe to appear as the official representative of the Federal Reserve System. But McCabe declined, knowing well that he would be placed in a very difficult position since he could not very well defend the Treasury's position. "As Chairman, it would have been difficult for him to oppose publicly without resigning", Eccles noted (Eccles 1951, p. 486). So Eccles went instead.

Eccles appears before Congress

Eccles had by this time already drafted his resignation letter to the President (his term was to expire in 1958), so that when he appeared before the Committee, he spoke out forthrightly. He urged Congress to control expenditures and balance the budget. The financing of war expenses was more complicated (now) than during the Second World War, as the economy then had idle resources. If the budget wasn't balanced now, "We shall lose the fight against totalitarianism, even though our military and foreign policies are successful in maintaining peace, if we permit inflation to sap the strength of our democratic institutions" (Eccles 1951a, p. 110).

Large holdings of liquid assets among households and enterprises added to inflationary pressure. He noted that

> as long as the Federal Reserve is required to buy Government securities at the will of the market for the purpose of defending a fixed pattern of interest rates established by the Treasury, it must stand ready to create new bank reserves in unlimited amount. This policy makes the entire banking system, through the action of the Federal Reserve System, *an engine of inflation.* (*Ibid*., p. 116)

He added that maintaining the interest peg was equivalent to issuing interest-bearing cash, since the Federal Reserve was in effect guaranteeing demand liabilities at 2½ percent (Eccles 1951c, p. 2). At that rate, there were far more sellers of government securities than buyers, indicating the public's unwillingness to hold them at existing rates. "The only way to restore the balance is to let interest rates go higher to meet public demands" (Eccles 1951a, 116).

Members of the Committee were concerned about the effects of a rate increase. Congressman Patman asked if it was not "the obligation of the Federal Reserve System to protect the public against excessive interest rates," and the Chairman wondered "if not prices of those securities would fall (and interest rates rise) if the Federal Reserve System abandon its support of Federal securities in the open market?" (*Ibid*., p. 179)

Eccles responded that the System had "a greater obligation to the American public to protect them against the deterioration of the dollar" (*Ibid*., p. 152). He agreed that there would be transitory problems related to a change in rate policy, but noted that "they are not nearly as formidable as the problems that we take on if we accept a frozen interest rate structure" (*Ibid*., p. 118). He noted at the end that:

> All I am saying is this that either the Federal Reserve should be recognized as having some independent status, or it should be considered simply an agency or a bureau of the Treasury, whose primary function is to carry out the job of Government financing at the will of the Treasury, and at the rates established by the Treasury. (*Ibid*., p. 162)

Eccles Goes Public

As tensions rose between the Treasury and the Federal Reserve, Eccles was soon to play a pivotal role in the unfolding drama. The prelude to this important event was the exceptional meeting of the Federal Open Market Committee with the President on 31 January, an unprecedented event that would forever change the history of the System.

The FOMC meets with the President

Up until the next FOMC meeting on 31 January, the Federal Reserve System was faced with heavy selling of the longest Treasury bonds. On 29 January, the Fed allowed the price to decline slightly (by 1/32), consistent with previous internal discussions that the peg would be maintained, but the premium gradually reduced. This change led to an immediate reaction from the Treasury, which ordered the Fed as the fiscal agent of the United States to purchase bonds at par and 22/32. As a result, the Fed purchased a token amount for the Treasury account at the higher rate, and the remainder at par and 21/32. (BGFRS 1951, p. 3).

When the FOMC met, McCabe informed it that the President wanted to meet with the entire committee later that same day. As Eccles noted, this was evidently the design of Treasury Secretary Snyder, who had been surprised by the strong negative reactions to his New York speech and tried to regain the initiative (Eccles 1951, p. 486). But it was nonetheless an exceptional request, and the first and only meeting of this kind in the history of the Federal Reserve System (Meltzer 2003, p. 703).

In preparing for the meeting, Sproul reiterated that it was important for the Federal Reserve to "maintain public confidence in the real value of the dollar and the Government credit and not in a fixed interest rate or in fixed prices of Government securities" (BGFRS 1951, p. 18). They should argue for more flexibility in short-term rates and reiterate the need for a higher rate on long-term Government securities to make them more acceptable to the public (*Ibid*.). Before they left for the meeting, they agreed to leave the talking to McCabe, and say as little as possible.

The meeting itself was anticlimactic. The President talked at length about the war effort and the need to maintain confidence in government paper, adding that he expected the Federal Reserve to play its part. But at no point was the issue of maintaining the peg explicitly raised, and none of the participants from the FOMC mentioned it either.

This may have been intentional, but some felt it was a missed opportunity to make things clear. "The meeting smothered the conflict in ambiguity; everyone seemed to agree but no one changed positions" (Meltzer 2003, p. 705). As the economist Herbert Stein later noted: "The meeting was a masterpiece of deliberate misunderstanding" (Stein 1969, p. 272).

For whatever reason, the President left the meeting with a feeling that the Federal Reserve had committed itself to maintaining the rate structure, while FOMC members were relieved since they had not committed themselves to maintaining the long-term rate.

Treasury pressure

Even though Treasury Secretary Snyder had not been present at the meeting, the Treasury immediately began to tell its version of what had taken place, including the Federal Reserve's continued support for the 2½ percent long-term rate. These stories infuriated Sproul and other Federal Reserve officials (Meltzer 2003, p. 705).

But they were even more surprised when Chairman McCabe received a letter from the President on the following day, in which he thanked the FOMC for its assurances "that the market for government securities would be stabilized and maintained at present levels" (Quoted in BGFRS 1951a, p. 3). The letter was a crude attempt (by Snyder) to coerce the Federal Reserve into supporting the present yield structure, though without any basis in what had been said at the meeting. McCabe's immediate reaction was to ask the White House to withdraw the letter. This, he noted, could be done without embarrassment for the President, since the letter had not yet been made public.

Eccles releases memorandum

However, later on Friday afternoon, when everyone had left their offices for the weekend, the White House released the President's letter to McCabe. Without consultation and with no opportunity for the Federal Reserve to respond, this was the Treasury's "ultimate attempt to impose its will on the Federal Reserve System" (Hyman 1976, p. 347). This was too much for Eccles. If the Treasury view prevailed, the Federal Reserve would, in performing it's most important function—open-market operations, be reduced to the level of a Treasury bureau.

It was seven o'clock in the evening and all the other members of the Board, including McCabe, had left town. Eccles was also about to leave when he received a telephone call from the press asking for a comment on the letter. He reflected on the situation for a while, before deciding that the best way for the Federal Reserve to respond would be for him to release the confidential memorandum from the meeting with the President. It would set the record straight and show that the attempts by the Treasury to impose its views had no basis in reality.

As a former chairman of the Federal Reserve Board, it was difficult for him to breach the confidentiality rules that he had so strongly advocated earlier. However, at this stage of his career in Washington, "he was driven by the conviction that if men lose their minds as well as their souls, there would be nothing left for the times to try" and he knew that he had to assume the responsibility of releasing the memorandum (Hyman 1976, p. 347). Thus "Eccles made a momentous decision" to go public (Hetzel and Leach 2001, p. 46).

Eccles was able to obtain a copy of the memorandum from the Secretary of the Board, without telling him what he intended to do with it. He then made copies for the press and released them the next day together with a personal statement: "I'm astonished [at the president's letter]. The only answer I can make is to give you a copy of the record of what took place at the White House meeting … Any other comment may be superfluous" (Eccles 1951, p. 496).

The story was front-page news on Sunday, 4 February. As Eccles noted, the general impression was that the President's letter did not give an accurate description of what had happened in the White House. The public clearly understood that the White House was putting pressure on an organisation that was meant to be independent of political influence. "As a result of this, public sentiment, and hence congressional sentiment, swung to the support of the Federal Reserve" (*Ibid*.).

Next move by the FOMC

By Monday morning "the fat was in the fire" (Eccles 1951, p. 496). McCabe called an immediate extraordinary meeting of the FOMC. This would be a crucial meeting he noted (BGFRS 1951a, p. 2). At the start of the meeting, Eccles explained his motivation for releasing the memorandum:

> I have no regrets. I did what I think was right. If I had to do it over, I would do exactly what I did. I think under the circumstances it was the way that I could best discharge my public responsibility, the way I could best protect the position of this System, as well as to protect my own record. I regret exceedingly that the situation developed to a point where releasing what was to be a confidential document seemed to me to be absolutely essential under the circumstances. I take the entire responsibility for it myself. I purposely avoided talking with anybody or telling anybody what I was going to do, because I did not want in any way to involve anyone else. I did not act on the advice of anyone or as the result of consultations with anyone. I merely want to say that for the record. (*Ibid*., p. 16)[51]

He went on to explain why he felt it was important for the Federal Reserve to resist the pressure from the Treasury to maintain fixed rates. He noted that when the peg had been

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[51] Sproul supported Eccles' publication of the memorandum. No other members voiced support or opposition.

decided back in 1942, there had been a great deal of slack in the economy. "The situation today is exactly the opposite". Despite a budget surplus, private credit was fuelling inflation (*Ibid*., p. 17):

> We cannot wait to act. Action is far overdue. In retrospect, I would say if anything, that we have been derelict in not acting sooner and more aggressively. We have failed to take as drastic and strong and aggressive action as the situation has been calling for. (*Ibid*., p. 17)

To those FOMC members who favoured caution, he noted that they had already tried to argue reason with the Treasury for more than a year without achieving any results. "We no longer have time to work it out in this way. I, for one, feel that the issue has to be faced" (*Ibid*., p. 18).[52]

McCabe then read out a reply to the President's letter stating the FOMC's support for the government securities market, but voicing disagreement with his interpretation of the meeting and what had been agreed upon (or rather not agreed upon) there. All but one of the members agreed to the letter,[53] which was duly dispatched to the White House. He also presented a supplementary letter sent to Secretary Snyder inviting the Treasury to discuss what policies might be advisable in the immediate future" and laying out the System's positions for these discussions (*Ibid*., p. 30):

- The Federal Reserve would for some time continue to support the par price of the longest-term restricted bonds.
- The Treasury would offer a longer-term bond with more attractive returns to non-bank investors.
- The Federal Reserve would limit its purchases of short-term Treasuries.

These terms would become the basis for the subsequent Accord between the Treasury and the Federal Reserve. With this change in policy, member banks would instead be expected to obtain their needed reserves primarily by borrowing from Federal Reserve banks (*Ibid*., p. 32).

The FOMC also agreed that the price of the long bond should be allowed to fall towards par in small but predictable steps. McCabe noted, however, that as long as the Fed

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[52] They also discussed the legal authority of the President under the recently enacted Defense Production Act of 1950 to direct the Federal Reserve Board or the FOMC in its operations. According to the General Counsel, this was not the case (*Ibid*., p. 14). However, the Legal Division was asked to check whether other legislation since the Banking Act of 1935 could give the Treasury a mandate to direct Federal Reserve policies in the monetary field (*Ibid*., p. 25).

[53] Governor Vardaman, who was a close associate with Snyder, would often disagree with the other FOMC members and was also at times accused of leaking information to the press.

could be instructed by the Treasury to buy at par and 22/32, they had to proceed carefully. They would have to "… exercise extreme care to assure that in carrying out the policies of the full Committee no grounds be given for a charge by the Treasury or anyone else of bad faith on the part of the Committee" (*Ibid*. p.40).

The Accord

Despite this attempt by the FOMC to clarify policy, on the following day, the President reiterated his understanding (at a press conference) that "the majority of the Federal Reserve Board agreed with him on his interest rate views" (*Ibid.*, p. 37). McCabe was obviously not getting his message across. In addition, Secretary Snyder announced that he would be going into hospital for an eye operation, and he therefore asked them to keep rates on hold until he was back. McCabe responded, "unless there is someone at the Treasury who can work out a prompt and definitive agreement …, we will have to take unilateral action" (Meltzer 2003, p. 708).[54] This then set in motion the consultations that would lead up to the Accord. Snyder appointed assistant undersecretaries Edward Bartelt and William McChesney Martin, Jr. to negotiate with the Federal Reserve. The Federal Reserve appointed Riefler, Thomas, and Rouse (Meltzer 2003, p. 708).[55]

Technical discussions

Technical discussions began in earnest on 20 February and then continued in the form of intensive consultations between the two sides in a spirit of goodwill. When the FOMC next met in early March, Riefler was able to report on the substantial progress made by the group. He noted in particular that "both sides agreed that monetization of debt must be stopped as far as possible" and that it was essential to proceed carefully "since the so-called feud between the Treasury and Federal Reserve was a most significant psychological factor in the current situation" (BGFRS 1951d, 10-11). The Treasury had also accepted, after extended discussions, that the Federal Reserve proposal was "essentially a package and not susceptible to very much compromise" (*Ibid.*, p. 11).

Martin had been invited to the FOMC meeting to present the Treasury's view. He noted initially that "we could not have had a more pleasant or more frank or more open

[54] McCabe was favourable to a postponement, but Sproul was opposed. He wanted to go ahead with discussions with the Treasury right away. There was also strong pressure from Congress to postpone (Meltzer 2003, p. 708n230).

[55] Woodlief Thomas was the Board's chief economist; Winfield Riefler was adviser to the Chairman; Robert Rouse was manager of the System Open Market Account.

discussions of the problem. I feel we got a good deal of education out of it. It at least gave us a better understanding of our mutual problem" (*Ibid*., p. 12). He stated that they had worked "in a perfectly honest and objective way," but still within the framework of Snyder's speech of 18 January in New York (*Ibid*., p. 13).

Martin endorsed the proposal from the Federal Reserve in principle, but sought assurances that the change in policy would not lead to sharp increases in interest rates: "We do not want to feel we are starting on a rising pattern of interest rates in what could be a period of war financing" (*Ibid.*, p. 17). The Treasury therefore wanted assurances that the Federal Reserve would support the current rates in the transition period, while the new non-marketable bond was being issued. He did not ask for indefinite support, but noted that such support should be forthcoming for the remainder of the year (*Ibid*., p. 19).

In the FOMC's subsequent discussions, several members were concerned about the extent and length of Federal Reserve support for the long-term rate (*Ibid*., p. 30). In addition, Sproul emphasised that in no way should the agreement be set within the framework announced by Secretary Snyder in New York. To facilitate further progress, the technical group was then asked to resume work immediately and clarify any remaining issues.[56]

When the FOMC reconvened on the following day, Riefler briefed it on the discussions of the previous night. He noted that the sticking point was the possible effect of the programme on interest rates and that it was important that both sides understood what a change of policy would mean in terms of market price and rates (*Ibid*., p. 32). It was especially important for the Federal Reserve to note that support for an orderly market did not imply support of par value. He noted that under the new framework, the Treasury would have to offer issues at attractive rates and not relying on the Fed for support (*Ibid.*, p. 33). There was also agreement that some support for the current peg would be desirable during the new bond issue, but that the Treasury did not see the need for support for long after the new offering, "We would not find ourselves going into May or June with a peg at that end of the market" (*Ibid*., p. 34).[57]

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[56] At this stage, Eccles withdrew from the meeting to go to Chicago for a speaking engagement; he was thus not present for the second day of the meeting, but he gave his support to the draft accord before leaving.

[57] As presented to the FOMC on 1 March, the resulting agreement reflected Riefler's original ideas. The Federal Reserve would keep the discount rate at 1¾ percent through the end of 1951. The Treasury would remove marketable bonds from the market by exchanging them for a nonmarketable bond yielding 2¾ percent. To make those bonds liquid and thus more attractive to the market, the Treasury would exchange them upon request for a 1 ½ percent marketable five-year note. During the exchange, the Federal Reserve would support the price of the five-year notes. That support was central because the value of the nonmarketable bonds

To assist in the final discussions and preclude the possibility of misunderstandings, the FOMC then laid out its position in the form of a seven-point programme (see Appendix 2 for details).

The Accord

When the FOMC's executive committee met on 3 March, McCabe referred to his conversation with the President, who continued to be concerned about what would happen to long-term bonds. McCabe had responded that it was difficult to know what might happen, but he was confident that "as the public came to feel that the Government market was no longer regulated, there would be greater confidence in it" (BGFRS 1951e, p. 3). They then discussed how rapidly the market could move, and agreed that the System account would have to be "played by ear" during the very first days (*Ibid*., p. 4).

Chairman McCabe then referred to the announcement that would be issued jointly by the Treasury and the Federal Reserve. The statement read as follows:

> The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt. (*Ibid*., p. 6)

At the same time, they were informed of the Treasury's conversion announcement, offering for a limited period "a new investment series of long-term nonmarketable Treasury bonds in exchange for outstanding 2 ½ percent Treasury bonds of June 15 and December 15, 1967-72" (*Ibid*., p. 7).

Riefler added that, as agreed upon with the Treasury, there would be no written understanding as to the extent of the System's support for the longest-term restricted bonds (at 21 or 22/32 above par), although they would stick to the previous agreement of System support up to USD 200m. Also, there would be "the utmost secrecy about the terms of the understanding" to facilitate the success of the new conversion offering (*Ibid*., p. 8).

Eccles used the occasion to note that he reluctantly supported the agreement with the Treasury, primarily since the conversion issue now "prejudged the market" rather than reflecting "the real public market". However, he realised that the compromise programme was the best they could get under the circumstances and that after all "it was a very important step in the direction of a more flexible market and greater freedom in the

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depended upon the price of the five-year note. However, the Federal Reserve made no commitment to support the note's price beyond purchases of USD 200m (Hetzel and Leach 2001, pp. 50-51).

determination of System open market policies." McCabe added that "the biggest hope in the agreement was the fact that it marked a new era in Federal Reserve–Treasury relations," but he also noted that "it was only a beginning of a period of better understanding" and both parties would have to work hard "to see to it that this new spirit of cooperation succeed" (*Ibid*., p. 12).

The FOMC then approved the agreement. And the next day, Treasury Secretary Snyder approved it as well. The joint statement was then published on Sunday, 4 March.[58]

Aftermath

Even though the Treasury had lost the battle of the peg, it did not abandon the fight. Secretary Snyder let the President know that he no longer had confidence in Chairman McCabe. Without a working relationship with the Treasury, McCabe could no longer function. McCabe sent a bitter letter of resignation, but later resubmitted a bland version when asked to do so by the White House (Hetzel and Leach 2001, p. 51). Shortly afterwards, the President appointed William McChesney Martin, Jr., the Treasury assistant undersecretary who had so ably conducted the discussion on the Accord, as the new chairman of the Board of Governors.

In the press, this was widely understood to be the Treasury's revenge, and that the Federal Reserve had won the battle but lost the war. That is, the Federal Reserve had broken free from the Treasury, but then the Treasury had recaptured ground by installing its own man at the helm (*Ibid*., p. 52). Ironically, however, Martin turned out to be just as eager in defending the Federal Reserve's independence as his predecessors.[59] He would go on to serve as chairman for almost nineteen years; the longest term of any chairman to date.[60]

The market reaction to the Accord was modest. The refunding into the 2¾ percent nonmarketable bonds in April did not substantially change the yield on other long-term debt (Meltzer 2003, p. 713). During the conversion period, the Federal Reserve purchased five-year notes as promised to support the price. However, when the Federal Reserve had spent the agreed support amount in the first three days, the Treasury called and wanted more support. That request was refused, and there was nothing more the Treasury could do about the matter. Henceforth, the Federal Reserve ceased to be party to the system of pegged prices,

[58] At the time, press reports of the Accord did not view it as a major change in either policy or Federal Reserve independence (Meltzer 2003, p. 712n234).
[59] Leon Keyserling, chairman of the President's Council of Economic Advisors at the time, said that "Martin promptly double-crossed the President" after becoming chairman (Hetzel and Leach 2001, p. 52).
[60] Alan Greenspan served for nearly as long: 18.5 years. Eccles served for almost 16 years.

with their inflationary consequences. “Eccles had won his last battle in Washington” (Hyman 1976, p. 351).

ECCLES’S POSITION ON CENTRAL BANK INDEPENDENCE

Eccles became a pivotal player in the Accord drama when he released the classified memoranda from the FOMC meeting with the President, but he did so to protect the integrity and independence of the Federal Reserve. The liberal press admonished Eccles for his perceived switch from New Dealer to conservative (Weldin 2000, p. 215), but his actions fit well with his broader view of the dual mandate of central banks to fight inflation and prevent depression. For Eccles, central bank independence became a necessity in 1951, not as an absolute virtue, but more like a tactical tool to withstand Treasury pressure for inflationary war financing.

Not an omnipotent Fed

Eccles favoured consultations and consensus. When the Board discussed monetary policy during the Second World War, he would tell his colleagues “it was a mistake for the central bank in any country to regard itself as being completely independent.” It should express its views and thereafter “not try to make its will prevail, but cooperate in carrying out the program agreed upon by the Government” (BGFRS 1942, p. 8).

However, as the war dragged on without signs of more tax financing, Eccles gradually became more concerned with the inflationary consequences of continued bank financing of the fiscal deficit. He was also sceptical of the Treasury’s bond programmes, and argued that a more restrictive credit policy was needed. But he did not favour a fully independent, omnipotent central bank:

> I agree with those who say that Treasury domination of Federal Reserve credit policy is dangerous. I do not go along, however, with the sophomoric contention that the Federal Reserve should be omnipotent or that it should be free to assume an attitude that might be described as “the Treasury be damned.” (Eccles 1951b, p. 1)

The conflict with the Treasury intensified during the post-war period and particularly after the outbreak of the Korean War over continuance of the cheap money policy of the wartime period of heavy deficit financing. Eccles had long favoured administrative measures to curb the growth in private credit, but in early 1951 he felt it was time for the Fed to act independently. With the Treasury facing a deficit of unknown size, it was no longer the responsibility of the Federal Reserve System to underwrite the public debt at fixed prices, but rather “to do everything in its power to curb further expansion of the money supply and further depreciation in the purchasing power of the dollar” (Eccles 1951c, p. 4).

Therefore, the Federal Reserve System should not continue to support the market for government securities at fixed prices. In the midst of the FOMC meeting in early March, when the Federal Reserve was discussing the final touches of the Accord, Eccles went to Chicago to defend their position:

> If the Congress does not want the Federal Reserve System to carry out its present statutory responsibilities it should repeal or redefine its powers. Until such time as it does, the System has no choice under the present impact of inflationary pressures but to use its powers in a manner consistent with its responsibilities to the public as well as to the Treasury. To do otherwise, would be to fail in its public duty and would not be in the real interest of the Government. A greater degree of independence on the part of the Federal Reserve System is long overdue. (Eccles 1951c, p. 4)

But, added Eccles, “neither the Federal Reserve nor the Treasury should be omnipotent or dominant; each should consider itself to be an equal partner charged with responsibilities of equal weight” (Eccles 1951b, p. 8).

Reluctant advocate of flexible rates

Eccles was a reluctant advocate of flexible interest rates. Immediately after the Second World War, he opposed increased rates because “it would add to the interest cost of the Government debt and raise bank earnings” (Eccles 1946, p. 2). A sharp rise in rates could also cause “as serious drop in the bond market” (*Ibid*.).

As late as 1949, Eccles was still supporting the low interest rate policy. In a letter to Senator Douglas he quotes from an earlier letter to Treasury Secretary Snyder that “our purpose and policy are based <u>not</u> on a desire for a higher level of interest rates, but entirely to discourage needless monetization of the debt through a wartime mechanism” (Eccles 1949b, p. 11; underline added).

At the FOMC meetings leading up to the Accord on 4 March, President Sproul of the New York Federal Reserve was pushing hardest for independence and flexible rates. Several of the other Board members were still supporting alternative measures to control the growth of reserves, which in their mind was the main problem.[61] Eccles finally sided with Sproul, and noted that "… at no time in the more than 16 years during which he had been a member of the Board was there greater need for courage and realistic leadership in monetary and credit matters" (BGFRS 1951c, p. 9). Eccles had concluded that the economy could no longer withstand a system of direct controls for an indefinite period, and that it was time the government faced up to the situation and offered investors attractive rates (*Ibid*., p. 10).

When he appeared before Congress in January 1951, Eccles again noted that the Federal Reserve was *not* interested in higher interest rates as such, but only as they could help in curbing the sale (by banks and insurance companies) of government securities, which added to the reserves and deposits of the banking system (Eccles 1951a, pp. 175-6). To curb the sale of government securities, it was necessary for the market to become more self-supporting. "The incidental result of such a development, under current conditions, will be somewhat higher interest rates," noted Eccles (Eccles 1951c, p. 2).

It is interesting to note how Eccles gradually became a supporter of more flexible rates. In a letter to *American Banker* in 1951 he defended his change of view, and noted that the situation had changed dramatically (Eccles 1951d). Back in 1948 there had been a real risk of deflation, whereas now (in 1951) prices were increasing rapidly. As a result, he argued, the money supply had been declining, whereas now (in 1951) it was expanding rapidly. He therefore accused the editor of misrepresenting his views:

> The purpose of the article was to make it appear that I am inconsistent in advocating a freer market for long-term Government securities now whereas I earlier favored support for the 2 ½ long-term yield. But the article completely fails to take into consideration the great difference between the monetary and credit situation then as compared with the situation now (*Ibid*.)

Despite his "conversion" to flexible rates, Eccles remained committed to long-term low rates (Hetzel and Leach 2001, p. 37n8).

> In addition to believing that we need a flexible monetary policy with fluctuating interest rates, I believe that we need a generally low level of interest rates as a longer-run matter even though higher rates may be required at times to retard inflationary developments. (Eccles 1950, p. 9)

Lower rates would, according to Eccles, support aggregate spending, keep a downward pressure on savings, stimulate investment, favour the low and middle-income

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[61] One Board member (Mr. Szymczak) made it clear that the responsibility of the System under the law was to regulate the availability of bank reserves and that, therefore, the System was not interested in increases in interest rates as such but rather in policies which would enable the System to discharge the responsibilities placed upon it by Congress even though such policies resulted in higher rates (BGFRS 1951c, p. 14)

groups in the distribution of income, and keep down the financial costs of production and hence provide goods more cheaply (Eccles 1950, p. 9). His views on the long-term direction of interest rates were thus unaffected by his tactical support for flexible rates in the acute conflict with the Treasury in winter 1950-51.

Importance of symmetric policy response

For Eccles, the fight against inflation in 1951 required a strong and independent Federal Reserve. Since Congress would not give them additional powers to rein in excessive reserve growth, they would have to use the powers Congress had already granted them. The war effort (in Korea) would come to nothing if the destructive powers of inflation were allowed to run their course. As Senator Douglas observed: “In the eyes of those who want to destroy democracy and capitalist institutions, inflation is a cheap way of achieving their collapse” (Meltzer 2003, p. 703n218).

It is interesting to note that Eccles’s concerns for post-war inflation came early. He warned during the war about “a situation in which individual and business consumers, if permitted to buy freely, would in many fields try to purchase greatly in excess of what is available” (Eccles 1944, p. 1). He argued for a shift in policy from the active fiscal stimulus during the Depression years to a more restrictive policy that would enable resources to be shifted into war production and control inflation.

Eccles found that many of his Keynesian allies from the 1930s were slow to perceive this post-war problem. Many of them continued to be concerned with the risk of a major slump after the war.[62] “Whenever Eccles looked at the update for the ‘liquid assets’ in the nation, the new (upward) figures persuaded him that the immediate post-wars years would be marked by a ‘classical’ inflation where ‘too much money chases too few goods’” (Hyman 1976, p. 288). But Eccles was always conscious of the dual mandate of the Federal Reserve: to preserve maximum employment while controlling inflation. This required a symmetric policy response: “It is the duty of the Government to intervene in order to counteract as far as possible the twin evils of inflation and deflation” (Eccles 1935c, p. 1). Eccles was therefore perfectly happy to support active “pump priming” by the government in the 1930s, while embracing the fight against inflation in the early 1950s. As he had pointed out back in 1935: “Inflation is to be feared only after we have achieved recovery” (Eccles 1935b, p. 15).

[62] Walter S. Salant and Gerard Colm were among some of the other (US) economists who were quick to recognize the new realities of post-war inflation (Hyman 1976, p. 288).

Was Eccles a "weak" chairman?

Central bank independence was not an absolute virtue for Eccles. Some have described his tenure as Chairman of the Federal Reserve in the 1930s as "virtually an assistant secretary of the Treasury for monetary affairs" (Timberlake 1999, p. 3). But for Eccles, the proper role of the Fed during the Depression was to support the Roosevelt Administration's fiscal programme.

Meltzer (2003) describes Eccles as a weak and inconsistent chairman who failed to preserve the integrity of the Federal Reserve under Roosevelt, and only later (after the Second World War) recognised the need for more independence. However, this view misses the consistency in Eccles's economic views, especially on the issue of compensatory finance. As much as the Federal Reserve should fight alongside the Administration in waging war on unemployment, they should be equally vigilant in the fight against inflation. If the Administration prevailed in its "easy money view", then the Fed had to take on the fight alone.

When the FOMC was discussing how to meet the Treasury challenge in February 1951, Eccles looked back at the post-war period and noted that the fight was long overdue:

> As I look back to 1946 and 1947, when the Treasury and a budgetary surplus and the war was over, particularly when we were having our troubles with Secretary of the Treasury Vinson, we should have taken a stronger stand. If we had had a row, I could have resigned. As I look back on it, I regret I did not take a stronger stand for obtaining substitute authority from the Congress. But until we get that authority, it is up to us to use what we have. (BGFRS 1951a, p. 19)

Eccles came around from his guarded support for policy independence in the early war years to more passionate support for central bank independence after the war. Once removed from the chairmanship of the Federal Reserve Board, Eccles became even more outspoken against the Truman Administration's economic policies. The onset of the Korean War exacerbated the controversy between Eccles and the Administration. While he continued to believe that fiscal policies were more potent against inflation than monetary policy, he finally supported more flexible rates in the face of strong inflationary pressures.

His repeated proposals for budget surpluses and credit constraint irritated the Administration and alienated the bankers. But Eccles would persist in promoting his causes despite weak political support. Gradually Congress would come along as a supporter of the Federal Reserve's position, but the support from top-ranking Republicans Robert Taft and Arthur Vandenberg may have annoyed the President so much that Eccles' demotion (in 1948) was inevitable (Weldin 2000, p. 177). Despite this, Eccles continued his fight and finally won. As an active supporter of Sproul and McCabe, he was instrumental in bringing about the Accord.

Marriner Eccles has been accused of turning with the wind, and being a weak and inconsistent chairman and then an unexceptional member of the Board of Governors of the Federal Reserve System. I view him rather as a pragmatic policymaker who understood that the appropriateness of the central bank's policy tools and governance structure depends on the situation at hand. Therefore, central bank independence and inflation fighting should not be seen as a holy grail to be defended at all costs and at all times.

LESSONS FOR CENTRAL BANK INDEPENDENCE

Gavyn Davis (2012) claims that the battle of the peg "was probably the greatest political battle in the history of central banking." This "epic struggle between a US president who stood on the verge of a nuclear war, and a central bank that was seeking to establish its right to set an independent monetary policy resulted in an improbable victory for the central bank" (*Ibid*.) Davis thinks the Accord provides important lessons for central banks today that are under increasing pressure to support their governments and cap bond yields. He believes that "this is dangerous territory, which lies right at the heart of a government's relationship with its central bank."

Yet as we have seen, the history of the Accord can also be read differently, with a number of lessons to be learned. Seen in a wider historical context and in light of the actions of Marriner Eccles, it is my contention that the Accord should be interpreted as part of a broader vision for a compensatory central bank. According to Eccles, the central bank should be as concerned with depression as with inflation. Thus, the lesson for today is that central banks should be more concerned with the unemployment problem and supportive of countercyclical fiscal policies. As Eccles noted before Congress in 1933:

> Unless we adopt the necessary corrective measures, we can only expect to sink deeper in distress, with possible revolution, with social disintegration, with the world in ruins, the network of its financial obligations in shreds, with the very basis of law and order shattered. Under such a condition nothing but a primitive society is possible. Why risk such a catastrophe when it can be averted by aggressive measures in the right direction on the part of the Government? (Eccles 1933, p. 705)

The lesson I draw from the Accord is for a less independent, but more effective central bank that acts in a truly countercyclical fashion in tandem with aggressive fiscal policies. To achieve its objective of business stability, the central bank will also have to gain more control over private credit creation.[63] Only in this way can the central bank be a truly compensatory force in the economy.

Different lessons from the Accord

Lesson 1: It is remarkable how widely different lessons can be drawn from the history of the Accord. As noted, the Accord is subject to a number of possible interpretations. Many economists invoke the Accord in support of more independent monetary policy, free from fiscal dominance. Davis (2012) views the Accord as the final "victory over fiscal dominance" and "as the moment when the modern, independent Fed came into existence." Citibank's global economics team reviews the Accord history and notes that (fortunately) there are now "broad understandings of the nature and importance of central bank independence—and the role that monetary policy can play in ensuring favorable economic outcomes" (Sheets and D'Antonio 2012, p. 1). This stronger intellectual framework should prevent a replay of the events following the Second World War. With substantial pressure now building up on central banks to keep rates low (in an environment with elevated government debts), "central banks will need to remain intensively focused on their core mandates and not become distracted by other objectives or political pressures" (*Ibid*., p. 14).[64]

McCulley and Pozsar (2012) provide another interpretation of the history of the Accord and the lessons from the 1930s. They support the current ultra-loose policy of the Federal Reserve and note that "it is actually somewhat similar to the framework of bond-price pegging that occurred during the years before the Federal Reserve-Treasury Accord of 1951" (McCulley and Pozsar 2012, p. 5n3). By keeping rates low for an extended period, the central bank supported the government's long-term borrowing programme. Unfortunately, fiscal authorities are currently obsessed with balanced budgets. "The problem for central banks currently is therefore not to protect their independence, but to help governments let go

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[63] For further discussion of this topic, see Moe (2012b).

[64] Interestingly, the US Treasury has recently considered issuing floating rate notes to dampen the negative effects of an exit strategy with increasing rates. The parallel to the 1950s is striking, when the Treasury converted the huge stock of outstanding fixed term debt at more attractive rates to soften the balance sheet effect of higher rates. But today, there is absolutely no reason for the Treasury to issue floating rate notes, according to Campbell Harvey, a finance professor at Duke University's Fuqua School of Business in Durham, North Carolina. "If interest rates go up, it puts the government at risk because they will need to come up with a lot of extra revenue to pay the interest bill" (Quoted in Liz Capo McCormick and Meera Louis, "Father Of Treasury Floaters Says Now Worst Time For Sales," *Bloomberg*.com, 30 April 2012, http://www.bloomberg.com/news/2012-04-29/father-of-treasury-floaters-says-now-worst-time-to-begin-sales.html).

of their fears of false orthodoxies that hold them back from borrowing and investing" (*Ibid*., p. 5).

Nevertheless, the Federal Reserve's new policy of fixing the expectations of long-term rates at a low level marks the end of a long period of "tussles" between the US Treasury and the Federal Reserve System, where the fiscal authority would have to guess how the monetary authority would react to its fiscal policy decisions. "The decades-long era of Sargent and Wallace's 'Unpleasant Monetarist Arithmetic' (1981) is over" (McCulley and Pozsar 2012, p. 6).

Indeed, the history of the Accord is subject to a range of interpretations, with different lessons to be learned. One group views the Accord as the end result of an epic struggle to gain central bank independence and price stability. Another interpretation would set the Accord in a broader historical context and view it as a step that was necessary at the time to counteract inflationary pressures, yet would refrain from drawing universally applicable lessons about central bank independence from this specific historical experience. Rather, the lesson is that central bank and treasury policies normally need to be coordinated, and that an independent central bank focused on (only) price stability is only one of many possible configurations for such coordination.

Finance ministries and central banks need to coordinate policies

Lesson 2: There is a permanent need for coordination between fiscal and monetary policy. During the Patman Committee hearings, Senator Douglas noted the "inevitable conflict" between the Treasury and the Federal Reserve, and the potential of the two agencies to run at cross-purposes (US Congress 1952a, p. 489). During discussions on the Accord, Assistant Undersecretary Martin would appeal to the Federal Reserve for agreement on the Accord since "we are in the situation of the Army and the Navy and we have to work together in a war" (BGFRS 1951d, p. 21).

This policy coordination problem has been extensively discussed in the academic literature. Woodford (2001, p. 70) notes: "Our results imply that a central bank charged with maintaining price stability cannot be indifferent as to how fiscal policy is determined." Sargent and Wallace (1981) discussed this coordination problem in their classical article "Some Unpleasant Monetarist Arithmetic." They noted that monetary and fiscal policy should interact in a coherent way in order to deliver a unique equilibrium (Park 2012, p. 4). They also noted that the public's demand for interest-bearing government debt might bind the monetary authority and thus possibly limit its ability to control inflation permanently

(Sargent and Wallace 1981, p. 1). The outcome would very much depend on the way fiscal and monetary policies are coordinated: "Like two samurai facing each other in a duel."[65]

Svensson (2012, p. 295) notes that this "duel" can best be resolved if each agency pursues its specific objective, with an eye to what the other is doing: "The equilibrium will be a non-cooperative Nash equilibrium rather than a coordinated equilibrium." However, Dixit and Lambertini (2003, p. 23) find that if fiscal policy is not constrained "it may not be worth incurring the political costs of putting in place any mechanism of monetary commitment."

The coordination problem was "solved" by applying the Golden Rule of balanced fiscal budgets. As Woodford noted, "commitments to budget balance or to deficit limits have achieved new prominence in macroeconomic policy in the same period that has seen increased emphasis upon central bank independence and actively anti-inflationary monetary policy, both in the US and in the European Union" (Woodford 2001, p. 71). Committing the Treasury to balanced budgets would enable an independent central bank to stabilise the price level. "Establishing and maintaining clear boundaries between monetary and fiscal policies protects the independence of the central bank and its ability to carry out its core mandate—maintaining price stability" (Plosser 2012b, p. 4).

The global financial crisis has led to a renewed discussion of the best way to coordinate fiscal and monetary policy. Goodfriend (2001, p. 24) would prefer "the Fed to perform only those functions that *must* be carried out by an independent central bank," and Lacker (2009, p. 7) adds that, "the Fed's primary focus should be the management of its monetary liabilities" (and nothing else). They have been concerned with the recent quasi-fiscal liquidity operations during the crisis and think that such credit policies could compromise central banks' independence and even their inflation targeting credibility. Peter Praet (2012, p. 5) discusses this policy challenge in the context of the current financial crisis in the euro area:

> When calls are made for a central bank to play the role of "lender of last resort" in government bond markets, such calls effectively amount to the central bank being asked to directly fund illiquid sovereigns, either via direct interventions on the primary market or by extending direct credit lines. Such activities are not legally within the reach of the ECB, since the Treaty clearly imposes the prohibition of monetary financing (Article 123 TFEU). There must not be any

[65] "A Japanese Duel," *Financial Times*, 17 June 2012, (http://www.ft.com/cms/s/0/6ee02358-b6eb-11e1-8c96-00144feabdc0.html#axzz25Pk8F4gq), on the policy standoff between the Bank of Japan and the Diet.

> circumvention to this prohibition. Again, this Treaty provision was not chosen arbitrarily. It is based on the experiences in many countries over several decades, which taught us that a central bank that bows to the needs of public finances cannot ultimately be successful towards delivering upon its medium-term oriented price-stability objective. In particular, moral hazard could weaken incentives for governments to pursue fiscal consolidation to safeguard or restore fiscal sustainability. This will ultimately endanger price stability and macroeconomic stability more generally.

While the situation in the euro area is idiosyncratic, there is a perception common among central bankers that they need to be "especially vigilant to shield monetary policy from attempts to engross it into inappropriate financial stability tasks" for such attempts may turn out to be "disguised aspirations to drag the well-established paradigms of monetary dominance towards the realm of fiscal dominance" (*Ibid*.).

However, as discussed above, this view of central banking elevates the Accord experience to a universal truth valid at all cyclical stages. Such an interpretation is, in my view, incorrect. And as Kocherlakota (2011, p. 3) recently observed: "It may turn out to be optimal for central banks to guarantee fiscal authority debts in some situations. If so, we again have to think of price level determination as something that is done jointly by the fiscal authority and the central bank—just as Sargent and Wallace taught us 30 years ago." [66]

The central bank is "independent within the government"

Lesson 3: Central banks should not be omnipotent.

According to President Sproul of the New York Fed: "The independence of the Federal Reserve System does not mean independence from the Government but independence within the Government" (US Congress 1952a, p. 983).

The subcommittee endorsed this view, since the Federal Reserve had substantial independence but was nevertheless accountable to Congress and the President, who appointed its board members. Despite this relationship, they noted that the Federal Reserve was formally independent and could make its own policy decisions without interference from the Administration.

But, the subcommittee added, "this formal independence of the Board of Governors from the President is inevitably limited by the hard fact that fiscal and monetary policy must be coordinated with each other and with the other policies and objectives of the Government" (US Congress 1952b, p. 52). According to the subcommittee, there should be more

[66] Narayana Kocherlakota is president of the Federal Reserve Bank of Minneapolis.

discussion of economic policies between the Executive agencies, since “what is needed is not the best monetary policy or the best fiscal policy, but the best over-all economic policy (*Ibid*.). The question was how this policy coordination should best take place.

Senator Douglas (who was a member of the Patman Committee) characterised the potential conflicts between the Treasury (wanting to issue debt at low rates) and the Federal Reserve (wanting to curb inflation with higher rates) as: “Here you are, twins, Siamese twins, but with no central coordinating nervous structure to dictate a uniform policy” (US Congress 1949, p. 489). His solution was a clearer mandate for the Federal Reserve—“to be a counterweight to cyclical economic fluctuations” (US Congress 1952b, p. 76). Clearer demarcations of each agency’s prime responsibility would be better than the Committee’s vague “common responsibility” theory of the Treasury–Federal Reserve System relations. And he noted in his written dissent to the report that the proper principle was “Good fences makes good neighbors”:

> In short, I make the point of differentiation of responsibility, and make it insistently, because it seems clear to me that we will have a better end result, and that the Treasury and the System will be better neighbors in the long run, the less they invite themselves in to play in each others' backyards. (US Congress 1952b, p. 76)

Despite his (and Eccles’s) efforts, the Federal Reserve’s objective remained unchanged, even though the Committee broadly endorsed the Federal Reserve’s newly gained independence. They noted, however, that …

> The independence of the Federal Reserve System is a relative, not an absolute, concept. It is good insofar as it contributes to the formulation of sound policy, and bad insofar as it detracts from it. Measured by this standard, the Subcommittee is inclined to believe that a degree of independence of the Board of Governors about equal to that now enjoyed is desirable. (*Ibid*., p. 52)

However, they added, “the Board of Governors, like all other parts of Government, must play as part of a team, not as an outside umpire, and must ultimately abide by the decisions that are made by Congress” (*Ibid*., p. 53).[67] In this sense, they expected the newly independent Federal Reserve to be a team player, not a solo flyer.

[67] See Appendix 3 for a summary of their views on the independence of the Federal Reserve.

The central bank should support business stability

Lesson 4: Central banks should fight inflation and prevent deflation.

The Accord was a solution to a specific coordination problem. At the time, the US economy was close to capacity and there were strong inflationary pressures. Today, many countries are facing mass unemployment and low inflation. This is certainly a situation in which Eccles would have advocated fiscal expansion supported by central bank monetisation. But central banks are currently fiercely opposed to such action, as they continue to support their narrow mandates of inflation targeting (IT).

There is, however, a growing debate about the IT paradigm. Jeffrey Frankel have noted that the current policy regime failed to respond adequately to asset market bubbles and also give inappropriate policy responses to supply shocks and terms of trade shocks.[68] Other economists have also raised questions about the current IT paradigm. Blanchard (chief economist at the IMF) raised the question some time ago: "To be concrete, are the net costs of inflation much higher at, say, 4 percent than at 2 percent, the current target range? Is it more difficult to anchor expectations at 4 percent than at 2 percent?" (Blanchard et al. 2010, p. 11).

The Nobel Prize winner Robert Engle also observed that "a little bit of inflation would do a whole lot of good for the US economy, would certainly do a lot of good for the housing market. If we had just a little bit of inflation and house prices went up, all the sudden they'd be above the mortgages."[69] But such suggestions have so far been met with massive silence or have been described as irresponsible and "reckless".[70]

Eccles favoured a broader central bank objective that would "promote business stability and moderate fluctuations in production, employment, and prices" (US Congress 1935, p. 290). Senator Douglas wanted the Fed to be "a counterweight to cyclical economic fluctuations" (US Congress 1952b, p. 76). Both would probably have endorsed the leading candidate to take the position of preferred nominal anchor—nominal GDP targeting.

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[68] Jeffrey Frankel, "The death of Inflation Targeting." *VOX.EU*, 19 June 2012. http://www.voxeu.org/index.php?q=node/8106. The Governor of the Bank of Canada, Mark Carney, has also voiced support for a reconsideration of central bank objectives; see his speech on central bank guidance (2012).

[69] Quoted in Sandrine Rastello, "Engle Joins Krugman Suggesting Higher Inflation for U.S.," *Bloomberg*, 1 May 2012, http://www.bloomberg.com/news/2012-05-01/engle-joins-krugman-suggesting-higher-inflation-for-u-s-.html.

[70] Paul Krugman's suggestion that the Federal Reserve tolerate inflation of 3 percent to 4 percent to boost the economy was rejected by Federal Reserve Chairman Ben S. Bernanke, who said such a policy would be "reckless".

As Frankel (2012) notes, fierce resistance persists among central bankers to give up the hard-fought anchor of 2 percent inflation. But as pressure builds for a change in policy paradigm,

> the attraction of nominal GDP targeting is that one could set a target for nominal GDP that constituted 4 or 5 percent increase over the coming year—which for a country teetering on the fence between recovery and recession is in effect a 4 percent inflation target—and yet one would not (formally) give up the hard-won emphasis on 2 percent inflation as the long-run anchor.

Thus, nominal GDP targeting could help address current economic problems as well as provide a more symmetric and therefore durable monetary regime for the future.

Control of private finance is a prerequisite for financial stability

Lesson 5: Central banks need to regain control of the money supply.

Excessive private credit creation was the key policy challenge facing the Federal Reserve after the Second World War. The Truman Administration ran budget surpluses for several years, but vigorous bank lending neutralised their effects. "The banks, in other words, created an amount of money just about as fast as the Federal Government, through its fiscal policy, contracted the money supply" (Eccles 1948b, p. 8).

Eccles and his contemporaries were deeply concerned about banks' ability to "create money". This quote from a Federal Reserve paper to Senator Douglas in 1951 illustrates their thinking:

> Most of us … are likely to suppose that the banker lends to other people the money that we deposit in his bank. That is not the case if we look at the banking system as a whole. The outstanding fact, which is so little comprehended, even among bankers who are supposed to know about such things, is that the banking system creates money. (BGFRS 1951b, p. 3)

Over time, the concern with excessive money growth has shifted more towards control with the fiscal deficit and how to constrain the Treasury's ability to create reserve money. For example, Woodford (2001, pp. 70-71) notes that "a central bank charged with maintaining price stability cannot be indifferent as to how fiscal policy is determined. A desirable solution will be to constrain fiscal expectations so that stable prices will not require explosive debt dynamics."

But the recent crisis showed that a rapidly growing banking system can push the financial system over the brink through uncontrolled money growth and additional expansion of "near-moneys." This was a policy problem that was very much discussed by

Eccles and his colleagues, as they tried to figure out how the government could regain control of the (growth of) society's money supply.[71] This problem of runaway credit was also notable in many countries before the recent crisis; it was private credit that was the big problem, not large fiscal deficits. Even so, for many economists this feature of the crisis has been hard to comprehend. As Gorton and Metric (2012, p. 1) noted recently: "Many professional economists now find themselves answering questions from their students, friends, and relatives on topics that did not seem at all central until a few years ago, and we are collectively scrambling to catch up."

But the key dynamics of the recent crisis—massive leverage and credit expansion, fed by a shadow banking system that contributed to a housing bubble and then a crash—had long been a central part of the theoretical tradition of both Keynes and Minsky.[72] Now these insights have to be integrated into mainstream economic thinking as well as a new paradigm for central banking that focuses as much on controlling private credit as it is concerned with public deficits.

Deficit financing and the challenges for central bank independence

Lesson 6: Central banks should support compensatory fiscal policy in a depression.

Eccles argued forcefully that only the government had the money-creating powers that could end a depression. He argued correctly that a nation that borrows in its own currency can never go bankrupt, since "it owes the debt to itself." The central bank should therefore support such fiscal efforts through monetisation, since there will be no immediate risk of inflation.

Eccles's heterodox policy position is at odds with current central banking doctrine, as articulated by Federal Reserve Bank President Plosser:

> When the Fed engages in targeted credit programmes that seek to alter the allocation of credit across markets, it is engaging in fiscal policy. While it is popular to view such blurring of the boundaries as "co-operation" or "co-

[71] See Moe (2012a) for a discussion of the policy challenges of strong credit growth and the expansion of shadow banking.

[72] Gerald Epstein, "'Memento,' the Meltdown and the Mainstream," *TripleCrisis*. 17 February 2012. http://triplecrisis.com/memento-the-meltdown-and-the-mainstream/. Epstein believes there is a reason for this neglect: "…the mainstream never changes its underlying theory which is based on the erroneous ideas that financial markets are, by and large, perfectly self-governing and efficient and that the market economy has strong self-equilibrating forces that always bring the economy back to full employment".

ordination" between the monetary and fiscal authorities during a crisis, ignoring the boundaries puts an economy's longer-term performance at risk.[73]

This awareness of the negative consequences of excessive money growth is the reason that country after country has moved to establish and maintain independent central banks, according to Plosser. Without independent central banks, the temptation to use the printing press in the absence of fiscal discipline would just be too great (Plosser 2012a, p. 3).

According to the prevailing paradigm "the bulk of the responsibility for resolving this crisis lies with national governments"[74] and "pressing the ECB into the role of ultimate buyer of public debt of individual member states would create the biggest conceivable moral hazard ever; … the prohibition of monetary financing is an indispensable element for a stable currency" (Issing 2011). Davis (2012) adds that "the idea that the central bank should place a cap on the level of bond yields [in the Eurozone] … is dangerous territory—which lies right at the heart of a government's relationship with its central bank."[75] And Peter Praet of the ECB adds: "It is essential that the clear demarcation lines provided in the Treaty are not violated or shifted. This would constitute a lasting damage and institutional regress to our well-serving monetary policy framework, which would be intricate or even impossible to reverse" (Praet 2012, p. 5).

But what will happen if the current austerity policy does not work and the crisis deepens? As Martin Wolf of the Financial Times notes,

> If the Eurozone were to enter a meltdown, UK policy would have to become far more aggressive. The government and the BoE would have to consider what are now regarded as widely unconventional schemes: large-scale direct funding of much enlarged fiscal deficits by the BoE; massive intervention by the BoE in foreign exchange markets; or large-scale government guarantees of bank funding and lending.[76]

The current policy mix of ultra-loose monetary policy and tight fiscal policy has delayed the recovery since the financial crisis in many countries. What is missing (in the US) today is "a fiscal authority with a willingness to spend and respond to the Federal Reserve's

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[73] Charles Plosser, "When a monetary solution is a road to perdition," *Financial Times*, 17 May 2012. http://www.ft.com/intl/cms/s/0/59e7a6f0-9f40-11e1-a455-00144feabdc0.html#axzz25in0pvrP.

[74] Jorg Asmussen, quoted in Peter Spiegel and Gerrit Wiesmann, "Draghi calls on EU leaders for 'brave leap,'" *Financial Times*, 24 May 2012, http://www.ft.com/intl/cms/s/0/281e032c-a5b6-11e1-b77a-00144feabdc0.html#axzz25Vp6kH6H

[75] Note the similarity with war financing in the US and the establishment of the peg of 1942.

[76] Martin Wolf, "Best not to pin hopes on UK's plan A-plus," *Financial Times*, 15 June 2012. http://www.ft.com/intl/cms/s/0/50b8a556-b6d9-11e1-8c96-00144feabdc0.html#axzz25in0pvrP.

unprecedented stance to willingly encourage and accommodate fiscal expansion to facilitate the private sector's deleveraging without depression" (McCulley and Pozsar 2012, p. 45).

What is needed now, as in the 1930s, is forceful monetary stimulus, both through fiscal and monetary means. The Federal Reserve is waiting for the government to do its part in the US, while so far the ECB has been doing its part only reluctantly, partly with reference to the Maastricht Treaty's provisions on central bank independence. For that reason, unfortunately, given the current sway of the doctrine of "balanced budgets", fiscal stimulus in Europe appears to be a long way off.

Monetary policy should not be set in stone

Lesson 7: We need a change in the current central banking paradigm.

The Patman Committee concluded that central banks should not be independent of the government (US Congress 1952b, p. 51). The Federal Reserve was accountable to Congress, which had delegated its right to issue money, and the Fed also needed to heed the views of the President and his Administration, even if from a safe distance. A review of the Douglas and Patman reports today reveal how closely intertwined monetary policy and politics were and are, and also how similar the policy issues are today.

The current crisis has led to renewed requests for more political control over the Federal Reserve (and some other central banks as well), and there have been several attempts to rein in their independence.[77] Sproul discussed these same issues in 1948, when he observed that

> I don't suppose that anyone would still argue that the central banking system should be independent of the Government of the country. The control which such a system exercises, over the volume and value of money is a right of Government, and is exercised on behalf of Government, with powers delegated by the Government. But there is a distinction between independence from Government and independence from political influence in a narrower sense. The powers of the central banking system should not be the pawn of any group or faction or party, or even any particular administration, subject to political pressures and its own passing fiscal necessities. (Sproul 1948; quoted in Meltzer 2003)

This interpretation of central bank independence was supported by the Patman Committee in 1952, but would not be consistent with the "omnipotent" role of the ECB. But as we have noted above, the independence of central banks can only be viable if it delivers

[77] After the recent crisis, Congress was successful in having the Government Accounting Office to conduct an independent review of the books of the Federal Reserve and the Fed was forced to reveal detailed customer information related to its crisis management operations.

superior policy outcomes over time. Today the current paradigm of an independent central bank targeting a narrow price goal is under renewed pressure because the model is increasingly seen as an obstacle to optimal policy execution. And, as our discussion of the Accord has shown, the current view of central bank independence is based on a misreading of the historical evidence.

Ugolini (2011, pp. 23-24) argues that “organizational structures for the provision of central banking functions vary over time in response to changes in the surrounding political and financial environment, and the present form is certainly not the only viable institutional solution”. Therefore, “the current organizational structures should not be seen as set in stone”. He adds that

> The same is the case for the implementation of government deficit monetization. In the long history of sovereign borrowing, periods of predominantly direct recourse to financial markets have alternated with periods of debt monetization – the latter being the norm in times of market dysfunctionality. As a result, monetization should not necessarily be seen as evil, but rather as an option to be subjected to a benefit-cost assessment – in the light, of course, of the constraints imposed by the institutional arrangements in force. (*Ibid*.)

On the whole, he concludes, “historical evidence suggests that the efficiency of any solution (concerning both organisational forms and monetary policies) crucially depends on the sustainability of the institutional arrangement backing them.” Eccles would have agreed. The history of the Accord should teach central bankers that while independence may at times be crucial for fighting inflation, support of government efforts to fight deflation and mass unemployment may at other times be more important.

In the spirit of Eccles, it is time for a more balanced central banking paradigm that supports compensatory policies.

POSTSCRIPT: WHAT HAPPENED TO ECCLES?

Eccles had already prepared his letter of resignation to President Truman (on 28 January 1951) when the conflict with the Treasury escalated in early 1951. On account of the conflict, he put off sending it until 1 March, which would mark the end of seventeen years in government service, sixteen of them on the Federal Reserve Board.

While Truman could be generous towards adversaries, he denied Eccles any such kindness. The President's response was "a pro-forma expression of good luck and good-bye, without a syllable of thanks for services rendered the nation" (Hyman 1976, p. 357). Apparently, Eccles's independence and repeated attacks on the Administration's policies had become too much for Truman to bear. Eccles's support for the continued investigation into the affairs of the Transamerica banking group may also have played a role (Weldin 2000).[78]

But the newspapers were full of acclamations. The *New York Times* wrote:

> The grip of the Treasury on the Federal Reserve policy was finally broken … largely because Marriner Eccles refused to relinquish the role he had assumed many years earlier as keeper of its conscience. Defying the Administration, Mr. Eccles forced this long smoldering controversy into the open by a coup that would have done credit to Theodore Roosevelt in his heydays. (Quoted in Hyman 1976, p. 358)

And the *Washington Post* noted "Mr. Eccles has been a model public servant, with ability joined to probity, who has earned respect of both friends and foes" (*Ibid*.).

Relieved of his official position, Eccles returned to his hometown of Logan, Utah, to deliver the commencement address the Utah State Agricultural College on 4 June. In that speech he made a final break with the Administration as he denounced the Truman Doctrine and the President's Cold War policy (Eccles 1951f, p. 4):

> In Iran, China, Korea, Indo-China and elsewhere we and the other countries of the Western World have failed singularly to provide the tangible benefits of democratic capitalism that would have averted the spread of communism. Instead, we have given our blessing and backing to reactionary governments that lack the confidence and support of the people. We have failed to realize that a large part of the world is in a state of economic revolution which we view as communist inspired and try to buy off with dollars or settle through war. We must recognize that the communists can only exploit the conditions that will continue to exist unless we ourselves, in our foreign policy, deal with the underlying causes of world-wide revolution.

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[78] Professor Lloyd Mints of University of Chicago observed, "Eccles was an adversary that even Harry Truman could not browbeat nor outmanoeuvre" (quoted in Timberlake 1999, p. 8).

He would go on to be an early vocal opponent of the American interventions in Indochina. His anti-war position was consistent with his earlier views on the financing of the Second World War defence expenditures and the need to match imperial policies with economic resources. That the US would go on to finance many more military adventures overseas by selling bonds to the rest of the world was unlikely to have been in his policy tool kit.

Soon after leaving the Board of Governors, he remarried and moved back to Utah, where he further consolidated his family's various industrial and banking interests. He also established a series of foundations involved in local affairs. The bank holding company he founded, First Security, remained independent until 2000, when it was acquired by Wells Fargo. It was the oldest multi-state bank holding company in the US.

Marriner S. Eccles died in 1977, aged eighty-seven.

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APPENDICES

Appendix 1: Accord Timeline

1951

3 January:	Chairman McCabe and Sproul meet with Treasury Secretary Snyder
17 January:	Meeting with President Truman
18 January:	Treasury Secretary Snyder; speech in New York
19 January:	Chairman McCabe meets Truman
31 January:	FOMC meeting with Truman
1 February:	White House press release from meeting
2 February:	White House release Truman's letter to McCabe
4 February:	Eccles releases memo of meeting with Truman to the press
6–8 February:	FOMC meeting
8 February:	McCabe and Sproul meet with Snyder
10 February:	Snyder goes to hospital
20–23 February:	Technical discussions Treasury–Federal Reserve
22 February:	Douglas presents his report on the floor of the Senate
26 February:	McCabe and Sproul meet with Truman et al.
2 March:	Snyder approves the proposed Accord
4 March:	Accord is published
9 March:	Chairman McCabe is fired
15 March:	William McChesney Martin, Jr. is appointed new Chairman
10 April:	Truman fires General McArthur
14 July:	Eccles resigns

Appendix 2: FOMC Proposed Principal Points of Treasury–Federal Reserve Understanding, 2 March[79]

1. Purpose: to reduce to a minimum the creation of bank reserves through monetisation of the public debt, while assuring the financing of the Government's needs.
2. Agree with the idea of conversion offering which should be designed to do the job of removing long-term restricted 2-1/2s from the market.
3. Will support outstanding 2-1/2s (restricted) at 21/32 above par on Junes and 22/32 above par on Decembers (in an amount up to a maximum of USD 200m and for a period not extending beyond 15 April 1951).
4. Discount rate: Board of Governors will approve no change during rest of calendar year without prior consultation with Treasury and unless very impelling circumstances.
5. Orderly market: with exception of support of long term 2-1/2s for fixed amount and fixed period during conversion offering, orderly market means maintaining orderly conditions without reference to par on any issue.
6. Public statement: brief general financial non-political statement.
7. Board requests your cooperation in seeking early supplemental legislation to restrict expansion of bank credit.

[79] The key documents from the Accord history can be found at the Board of Governor website: FOMC: Transcripts and Other Historical Material, 1951, including the extensive historical minutes from the March 1-2, 1951 meeting containing these points

Appendix 3: The Patman Report: Independence of the Federal Reserve System (Excerpts)

The first question which must be raised in any discussion of the independence of the Federal Reserve System is “independence from what?” … The Subcommittee rejects the idea that the Federal Reserve System should be independent of the Government. It agrees with Mr. Sproul, who said in a letter to the Subcommittee Hearings:

> I think it should be continuously borne in mind that whenever stress is placed upon the need for the independence of the Federal Reserve System it does not mean independence from the Government but independence within the Government.

The independence of the Federal Reserve System, which remains to be considered, is, therefore, to use Mr. Sproul's words “independence within the Government.” This independence is of two kinds— independence from the President and independence from Congress.

But, the formal independence of the Board of Governors from the President is inevitably limited by the hard fact that fiscal and monetary policy must be coordinated with each other and with the other policies and objectives of the Government if the Government is to be of the greatest service to the Nation.

This means that the Board of Governors must inevitably discuss and endeavor to reconcile its differences with the Executive agencies. What is needed is not the best monetary policy or the best fiscal policy, each as ends in themselves, but the best over-all economic policy. This is naturally most likely to be attained, from the point of view of the Federal Reserve, when its influence in Government policy formation is at a maximum.

The final aim, of course, is not that the Federal Reserve System should be independent, but that the country should have a sound economic policy. The independence of the Federal Reserve System is a relative, not an absolute, concept. It is good insofar as it contributes to the formulation of sound policy, and bad insofar as it detracts from it. *Measured by this standard, the Subcommittee is inclined to believe that a degree of independence of the Board of Governors about equal to that now enjoyed is desirable.*

Many of the policies which the Federal Reserve must advocate to maintain the soundness of the dollar during times of inflationary pressures are unpopular; yet it is necessary that they have a strong advocate in order to avoid a built-in inflationary bias in the economy. This end is best served by endowing the Board of Governors with a considerable degree of independence—thereby enhancing its bargaining power in the determination of over-all policy. But, the Board of Governors, like all other parts of Government, must play as part of a team, not as an outside umpire, and must ultimately abide by the decisions which are made by Congress.

(Excerpts from US Congress 1952b, p. 51-53)