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The Formative Years

The specific words "independent" and "independence" do not appear in the Federal Reserve Act, yet they often appear in descriptions of the Federal Reserve's relationship to popularly elected government. From the provisions of the Federal Reserve Act, and its legislative history, it is abundantly clear that the Federal Reserve System is intended to be insulated as far as possible from the short-term pressures of partisan politics, but it is just as clear that the Fed is ultimately accountable to Congress. This *Weekly Letter* discusses the initial concepts of independence and accountability that found expression in the Federal Reserve Act, and how these were tested and influenced by a number of events in the System's formative years.

Early concepts

At the start, the Federal Reserve's "independence" derived to an important extent from its regional structure and its initially limited menu of responsibilities. To a considerable extent, decisionmaking was decentralized under the Federal Reserve Act, which assigned the power and authority of implementing the System's goals to the regional Reserve Banks under the general supervisory authority of the Federal Reserve Board. The specific goals included a more "elastic" currency, achieved by providing a means for banks to borrow currency and reserves from the Fed, and more effective bank supervision.

However, early in the System's formative years, several key events served to redefine the notion of Fed independence. At the heart of many of these events was the Secretary of the Treasury, who served as ex officio member and Chairman of the Board of the Federal Reserve. Together with his Treasury colleague and fellow Board member, the Comptroller, he was in a position to exert considerable influence. And Treasury Secretary (later Senator) William McAdoo of California was no shrinking violet. He presided over a number of key controversies that changed the nature and concept of Fed independence, and that eventually led to major changes in the System's structure.

Encounters of the first kind

One controversy involved the efforts, in 1915, of Board members with strong "centralist" preferences to eliminate four and potentially six of the Reserve Banks—Kansas City, Minneapolis, Atlanta, Dallas, Boston and Richmond. These members included investment banker Paul Warburg, who had been hostile to some aspects of the Federal Reserve Act but who nevertheless was appointed to the Board by President Wilson in an effort to re-establish a spirit of cooperation with the financial community. In making their case, the proponents of reduction cited Warburg's dissatisfaction with the "petty frame of mind resulting from a twelve-headed system," but focused primarily on the operating losses incurred by the Banks singled out for elimination in their first year of operation.

Treasury Secretary McAdoo strongly opposed the move, as did a furious Congressman Glass, author of the Federal Reserve Act. An irate, "decentralist" President Wilson was prepared to remove the offending Board members "for cause," despite his prior reluctance to have any contact with Board members on the grounds that the moment he did so, "that moment I would be accused of trying to bring political pressure to bear." The Board backed off when faced with an opinion from the Attorney General that only the Congress could reduce the number of Reserve Banks, notwithstanding the language the Federal Reserve Act that indicated there could be fewer than twelve Reserve Banks.

On another occasion, shortly after the System was operational, Treasury Secretary McAdoo recommended that the Federal Reserve Board be subjected to the congressional appropriations process. This move was intended to eliminate the Board's dependence upon the Reserve Banks to finance its activities, and thereby to remove a potential source of Reserve Bank influence on the Board. Board member W.G. Harding subsequently claimed this was a ploy to make the Board an adjunct of the Treasury. On still another occasion, McAdoo recommended increasing the number of directors appointed by the Federal Reserve Board on the boards of each Reserve Bank to a majority in order to increase the influence of the Federal Reserve Board over the Reserve Banks.

War finance—calling the shots

The Treasury Secretary's influence on the Board was most pronounced in matters of "credit policy." As one raconteur of the Fed's early years noted, Fed officials at both the Board and the Reserve Banks had little time to "crystallize their thinking" on the Fed's role before the U.S. entered the first World War in the spring of 1917. By that time, most countries had abandoned the gold standard because of the dislocations and financing requirements of the war.

One of Treasury Secretary McAdoo's first acts in this period was to pressure the Reserve Banks into extending to the Treasury two tax loans totalling $300 million at interest rates of two and three percent, respectively. When other Board members and Reserve Banks balked at offering the Treasury below-market rates, McAdoo threatened to take over all the Reserve Banks' funds under the wartime Overman Act, which authorized the President "to make such redistribution of functions among executive agencies as he may deem necessary." McAdoo strongly objected to financing the war at market rates. Instead, he urged the Reserve Banks to set their discount rates, at which they lent to commercial banks, well below the coupon rates on current government issues to encourage the banks to borrow from the Fed and to use the funds to buy government securities.

The accommodation and facilitation of the Treasury's war financing requirements thus became the primary objective of Fed policy during World War I. "Everything else," according to the Treasury Secretary, "was thrown into the background. The Board necessarily was obliged to follow the policies of the Treasury Department and the Government." From America's entry into WWI through mid-1919, the federal debt soared from a little over $1 billion to $25 billion.

Fed officials generally recognized that the rapid expansion of money and U.S. securities bought through money creation to support the Treasury's borrowing requirements were among the causes of sharply rising prices (consumer prices rose by over 30 percent during the War), but they differed as to its importance. Many attributed most of the increase to shortages of basic materials and commodities in the face of "swollen" domestic and foreign demands. The demands, of course, were themselves swollen by the rapid increase in money financing, which caused the money supply to rise by 30 percent.

Accountability

It was clear from the outset that the Congress intended the Federal Reserve System to remain accountable to it, notwithstanding the provision for appointment of the members of the Federal Reserve Board by the President. (Originally appointed for staggered 10-year terms, Board members' terms were increased by the Congress to 12 years in 1933 and then to 14 years in 1935 specifically to provide them with greater insulation from influence by the Executive Branch. For the same reason, the Congress in 1935 removed the Secretary of the Treasury and the Comptroller from *ex officio* membership on the Board.)

Early in 1914, the Attorney General ruled that the Federal Reserve Board was an "independent Board or Government establishment" and not a Bureau or division of the Treasury (where the Board was housed), "establishment" being defined by the U.S. Code as an entity in the Executive branch. Another expression of Congressional intent as to whom the Federal Reserve Board was accountable was the requirement that the Board annually make a full written report of its operations to the Speaker of the House "for the information of the Congress," which report would establish a "direct relationship between the Board and the Congress."

Cornerstone of independence

The Federal Reserve Act and subsequent amendments also gave control over the classification and compensation of Federal Reserve employees to the new System (except for the salaries of Board members, which are set by Congress), and exempted both the Federal Reserve Board and the Reserve Banks from the congressional appropriations process. At the same time, the Federal Reserve Act stipulated that all System earnings in excess of expenses be paid to the Treasury. Over the entire period from 1914–1983, System payments to the Treasury have totalled $128 billion, representing almost 90 percent of the System's gross income (largely earnings on its investment portfolio). This aspect of the Fed's finances underscores the public and governmental, rather than the private, nature of the Reserve Banks and the System.

Even in the cornerstone of its "independence"—its financial self-sufficiency, a set of checks and balances has been built in. The Federal Reserve System never has been entirely free from audit of its expenditures. In his 1914 ruling, in which he determined that the Federal Reserve Board was an "independent government establishment" and not part of the Treasury, the Attorney General also concluded that the funds derived by the Board from its assessments on the Reserve Banks (the Board's source of funds) were "public monies" used to pay public officials and therefore were subject to audit by the Treasury. Following the establishment of the General Accounting Office (GAO) in 1921, the Comptroller cited the Attorney General's 1914 ruling as a basis for auditing Board funds, which it did until 1933 when the Congress amended the Federal Reserve Act explicitly to preclude audit of the Board (and the Reserve Banks) by the GAO. However, the Board became subject to audit by nationally known, independent audit firms, while the Reserve Banks were themselves subject to audit by the Board.

More currently, the Federal Banking Agency Audit Act of 1978 provided for audit by the GAO of each of the federal banking agencies, including the Board of Governors, the Reserve Banks and their branches, but with some carefully defined exemptions. These included the necessarily confidential and highly sensitive areas of monetary policy, open market operations, and transactions conducted on behalf of, or with, foreign governments and central banks. In such ways, Congress continually recognizes and reaffirms the importance of maintaining the Federal Reserve's independence *within* government.

Verle B. Johnston

Editorial comments may be addressed to the editor (Gregory Tong) or to the author .... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/24/84	Change from 10/17/84	Change from 12/28/83 Dollar	Change from 12/28/83 Percent Annualized
Loans, Leases and Investments[1 2]	183,961	321	7,936	5.4
Loans and Leases[1 6]	165,296	346	9,941	7.7
Commercial and Industrial	49,894	263	3,931	10.3
Real estate	61,119	33	2,220	4.5
Loans to Individuals	30,407	92	3,756	17.0
Leases	5,051	2	– 12	– 0.2
U.S. Treasury and Agency Securities[2]	11,548	– 66	– 959	– 9.2
Other Securities[2]	7,117	41	– 1,046	– 15.4
Total Deposits	189,466	– 774	– 1,531	– 0.9
Demand Deposits	43,339	–1,055	– 5,898	– 14.4
Demand Deposits Adjusted[3]	29,281	– 408	– 2,050	– 7.9
Other Transaction Balances[4]	12,037	– 275	– 738	– 6.9
Total Non-Transaction Balances[6]	134,091	557	5,106	4.7
Money Market Deposit Accounts—Total	38,486	452	– 1,111	– 3.3
Time Deposits in Amounts of $100,000 or more	41,434	174	3,269	10.3
Other Liabilities for Borrowed Money[5]	20,235	1,448	– 2,772	– 14.5

Weekly Averages of Daily Figures	Period ended 10/22/84	Period ended 10/8/84
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	13	102
Borrowings	102	67
Net free reserves (+)/Net borrowed(–)	– 89	35

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately