Understanding the Federal Reserve – A historical perspective

by the Center for Popular Economics

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The Federal Reserve was created as a result of the demands of the Populists, a movement of farmers, small business owners and working people in the late 19th century. Much like the Occupy Wall Street movement of today, the Populists represented a wide range of ordinary people who came together outside the two political parties to fight the power of the banks and big corporations. One of the main demands of the Populists was the replacement of the gold standard with a flexible currency, so that there would always be enough money in circulation to meet the needs of the economy. Even though the banks have always had undue influence over the Fed, it's important to remember that it was created to limit their power, and to make money serve the real economy. If we want it to do that job better, the solution is not to dispose of it, but to democratize it – to take control of the Fed away from the banks.

One hundred years ago, the United States, like most other advanced countries, was on the gold standard. This didn't mean that gold was literally used for money – few people ever saw gold coins in their daily life. What it meant was that the supply of money was linked to the supply of gold. Banks could issue private banknotes – paper currency - but the amount they issued was supposed to be proportional to the gold in their vaults. Many people – especially bankers – thought this was normal, natural, even morally necessary. But it had a serious problem: As the economy grew, unless there were lucky gold discoveries, there was no way for the money supply to grow along with it. As a result, the economy was almost always short of money. The country often experienced deflation, or falling prices; debts became more burdensome, since the dollars that had to be paid back were worth more than the dollars that had been borrowed.

When prices are high, that's just another way of saying that money is abundant; when prices are low that means money is scarce. When something is scarce, that's good news for whoever owns it, and bad news for whoever needs it. Under the gold standard, money was scarce. That was good news for the owners of money – banks, creditors and the rich in general. And it was bad news for everyone else, whose wealth was in something other than money – productive businesses, farmland, the capacity to work. This was why the small businesses, farmers and workers of the country were so opposed to the gold standard. The most famous statement opposing the gold standard was Populist William Jennings Bryan's speech to the 1896 Democratic National Convention: “If they dare to come out in the open field and defend the gold standard as a good thing, we shall fight them to the uttermost, having behind us the producing masses of the nation and the world. We shall answer their demands for a gold standard by saying to them, you shall not crucify mankind upon a cross of gold."

Instead of the gold standard, the Populists wanted a government-issued, or "fiat" money, that could increase in line with the needs of the economy, eliminating the monopoly profits of the banks that controlled the scarce money supply under the gold standard. They demanded "a people's currency, elastic and cheap, based on the entire wealth of the country." For that, the country needed a central bank.

When the Federal Reserve was established in 1913, its mission was set by law as ensuring an "elastic" currency, just as the Populists had called for. The Fed was also supposed to end the bank panics and crises that periodically wracked the nation. It was intended to give the country a money supply that would rise hand in hand with the needs of the economy. The banks didn't support the creation of the Fed, but once it was clear they couldn't stop it they did everything they could to control the new institution. So while in other countries central banks were set up as regular branches of government, answering to elected officials, in the US the Fed chair is largely independent, and the Board of Governors that runs the Fed includes members chosen by private banks, as well as members appointed by the President. The result is that the Fed is always torn between the interests of the productive economy in having sufficient money, and the interests of those who control the money supply, in keeping it artificially scarce. In practice, this means an inflation-unemployment tradeoff. Most of us want to see strong growth and low unemployment, even if that means moderate inflation (that is, rising prices or a falling value of money). But finance wants to preserve the value of money at all costs, even if that means mass unemployment and the waste of the economy's productive potential.

This tension has run through the whole history of the Federal Reserve. The great conservative economist Milton Friedman blames the depth of the Great Depression on overly tight monetary policy by the Fed. The tragedy of the Depression, he believes, could have been avoided, or at least greatly reduced, if the Fed had simply increased the money supply. Some political conservatives today support a return to the gold standard, but Friedman understood that by tightly limiting the supply of money, the Fed's commitment to the gold standard was disastrous for the real economy.

For years after World War II, the Fed seemed to have learned its lesson. For three decades, it was committed to making sure there was a sufficient supply of money for the real economy. Thanks to the Full Employment Act of 1946, the Fed was now required to provide enough money to maintain full employment, even at the risk of inflation. As a result, for thirty years, prices rose, but unemployment stayed low and incomes rose faster. This period saw steadily rising wages, and some of the strongest growth in American history.

Unemployment is frightening for people who live on their labor. But inflation is frightening for people who live on their money. The high inflation of the 1960s and 1970s convinced the banks and other money-owners that things had gone too far, and they began pushing for tighter monetary policy – for a Fed that would do what it took to preserve the value of money, even at the cost of growth and employment. They scored their first big victory when, under President Carter, Paul Volcker became chairman of the Fed, and set out to bring down inflation by any means necessary. Like many supporters of tight money, Volcker was obsessed with reducing wages. He believed that the only way to preserve the value of money, was to break the power of labor. To do this, he raised interest rates to unprecedented levels, deliberately provoking the deepest recession of postwar history (or at least the worst until the Great Recession). As historian William Greider puts it, “Volcker believed that inflation would not be securely defeated...until workers and their unions agreed to accept less. If they were not impressed by words, perhaps the liquidation of several million more jobs would convince them.” When a delegation of legislators from farm states came to Volcker to plead for easier money, he bluntly replied, “Look, your constituents are unhappy; mine aren't.” Volcker's constituents were the banks.

The real economy was put through a wringer. Many industries, like steel, never recovered from Volcker's tight money. But inflation fell to low levels, and the owners of money could once again count on their interest payments. Loans were no longer paid back in cheaper dollars. Volcker had succeeded in his mission, and his successor at the Fed, Alan Greenspan, maintained Volcker's jobs-be-damned focus right up to the Great Recession."

Just as important from their point of view, they succeeded in holding down wages. Greenspan explicitly credited the economy's “extraordinary” performance to “a heightened sense of job insecurity and, as a consequence, subdued wages.” He was willing to keep interest rates low through the 1990s, he said, because workers were too “traumatized” to demand higher wages. By law, the Fed is supposed to have a dual mandate, preserving both stable prices and full employment. But under Volcker and Greenspan, it ignored the second half of that mandate, and “job insecurity” became a goal of policy instead of something to avoid. So while we have had low rates of inflation in the past thirty years, we have had repeated recessions followed by jobless recoveries, years-long periods when millions of Americans have been unable to put their skills and energy to work in paid employment. For lenders it has been the best of times. But for borrowers – homeowners, students, people with medical bills or between jobs, small businesses – it has been the worst of times. That's what happens when the central bank answers to the private banks and not to the democratically elected government.

In the current recession the Fed seems to be doing more to support employment, with unconventional policy like quantitative easing. Indeed, the willingness of Ben Bernanke to print money is probably one reason why the economic crisis in the US has not been as bad as in Europe, and in other places where central bankers have been more orthodox. (But it has been bad enough!) So why hasn't the Fed been able to fix the economy? Some people think it hasn't really tried – that is is still working for its real constituents in finance with what some Fed officials call a policy of “opportunistic disinflation”, taking advantage of high unemployment to push down prices and increase the value of money. If that's true, we need more pressure on the Fed to boost employment, even if that means several years of higher inflation. Other people think it's because the Fed doesn't completely control the money supply; even when the Fed loosens, banks still won't lend. Support for this view comes from the one trillion dollars of excess reserves banks are currently holding – in effect, cash that they are hoarding rather than lending. In that case, we need more penalties for banks that won't lend, like a tax on excess reserves. Or we need to bypass the banks entirely and let people borrow directly from the government. Still other people think that even if banks are willing to lend, businesses don't want to borrow because there is no demand. In that case we need more public spending on infrastructure and other public goods, and jobs programs.

In any case, what we *don't* need is a return to the inflexible currency of the gold standard. Instead, we need a democratic Fed, that no longer answers to the banks, but returns to its original mission of providing an elastic currency sufficient for the needs of production and trade. In the long run, we should ask if we need a banking sector, or at least one anywhere near the size that we have now. Why should private banks make money on government-guaranteed mortgages and student loans? But the bottom line is simple. It's the Fed's job to make money serve the real economy instead of vice versa. And it's our job to make sure that it does.