

“The 1951 Fed-Treasury Accord: Its Historic Significance and Relevance for Current Policy”

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OUTLINE

HISTORY

- WW 2 Federal Reserve Interest Rate Peg and Bond Price Support Program (1942-1951)
- Reaching the February 1951 Fed-Treasury “Monetary Policy” Accord (1947-1951)
- Bills Only (1953-1961)
- Fed-Treasury Transfers and Surplus Capital (1913-)

OUTLINE (2)

CURRENT POLICY ISSUES

- Fed “Credit Policy” in the Crisis (2007-8)
- We Need an Accord for “Credit Policy”
- Fiscal Features of Monetary and Credit Policy
- Need Fed Independence to Pay Int on Res without Creating Reserves to Sustain 2% IT
- Revisiting Fed-Treasury Transfers and Surplus Capital

WW2 Rate Peg and Bond Price Support

- April 1942, Federal Reserve agreed—
- 90-day Treasury bill rate pegged at $3/8$ percent per annum
- No such ridged rate for other govt securities
- Pattern set roughly $7/8\%$ Treasury certificates to 1-yr; Treasury notes 1 to 5-yrs, up to 2.5% for 25-yr bonds

Reaching Fed-Treasury Accord 1947-1951

- 1946--Wartime price controls lifted, burst of inflation reaching ~25% in 1947 to mid-1948; then mild ~3% deflation to mid-1950; then ~10% inflation from outbreak of Korean War (25 June 1950) to mid-1951...
- April 1947--Marriner Eccles (Fed Board Chair) Allan Sproul (NY Fed Pres) work out agreement with Treasury Secretary John W. Snyder to end posted T-bill rate (Truman refused to reappoint Eccles as Fed Board Chair, but stayed on Board)
- April 24th --Fed Board independently announces greatly enlarged transfers, to pay into Treasury 90% of net earnings
- July 1st --FOMC informed Treasury that Fed would act immediately to float the T-bill rate; Fed held most T-bills, and returned the higher interest to Treasury
- Fed independence preserved; pre-negotiated w Treasury

Reaching Fed-Treasury Accord (2)

- Mild 3% deflation from mid-1948 to mid-1950 relaxed Fed concern, but officials aware of need to break free of bond price support
- Employment Act of 1946 had made govt formally responsible for macro-stabilization, utilizing monetary policy
- Fall 1949—Joint Committee on Economic Report (JEC forerunner) held hearings on money, credit, and fiscal policies, led by Senator Paul Douglas
- Douglas hearings favor independent monetary policy support for the Employment Act
- Congress and press back independent mon pol

Reaching Fed-Treasury Accord (3)

- 1950—Korean War begins (June) and Chinese entry (November) precipitates 10% inflation, intensified debate about restoring monetary policy independence
- Fed forced to purchase large volume of Treasury bonds to defend the 2 ½ % ceiling; only outflow of monetary gold blunted the growth of high-powered money
- 18 January 1951--Treasury Secretary Snyder's speech unilaterally declared Fed support for 2 ½ % bond rate
- 31 January—President Truman invited entire FOMC to the White House; Feb 2nd Truman released letter indicating FOMC support; Feb 4th Sunday papers carry Marriner Eccles contradiction of Truman letter; Fed gains overwhelming Congressional and public support

Reaching Fed-Treasury Accord (4)

- March 4th 1951, “Fed-Treasury Accord” on Monetary Policy:
- “The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policy 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”
- March 9th William McChesney Martin appointed new Fed Board Chair
- April 1951--Treasury *exchanged* 2 ½ % bonds for 2 ¼ % bond to absorb some potential capital losses

Reaching Fed-Treasury Accord (5)

- Allan Meltzer (2003) points out Accord not inevitable, and worked because:
- Truman financed the Korean War by taxes rather than deficit spending
- Little expected inflation; no inflation premium built in interest rates
- Interest rates did not rise much after Accord
- Also, Truman fired McArthur on April 11, 1951, unpopular war, Truman didn't run again
- Eisenhower Administration more Fed friendly

Reaching Fed-Treasury Accord (6)

- Political Economy Lessons
 - 1) Independent powers exercised by the Fed at any time are determined in an equilibrium involving a balance among Congress, Administration, Fed officials, and public opinion mediated by the media and economic circumstances
 - 2) Independent Fed behavior is less a matter of rule of law and more a matter of evolving power relationships in reaction to changing political and economic circumstances
 - 3) The views of particular leaders in prominent positions matter hugely for how the Fed exercises its independent powers

Bills Only (1953-1961)

- March 1953--FOMC unilaterally adopts “Bills only” under Martin’s leadership (NY Fed Pres Allan Sproul opposed)
- Bills only confines operations of System account to the short end of the Treasury market—Fed attempts self-imposed limit on fiscal initiatives unrelated to mon pol
- Reduces Fed interference in securities market
- Limits conflict between Fed and Treasury, in principle
- Assigns responsibility for debt maturity distribution to Treasury, in principle
- Fall 1959—BUT market rate at which Treasury could issue bonds exceeded 4 ½ % legal ceiling on coupons at which Treasury legally could issue 5+ yr debt (dated from 1918 legislation)
- Treasury requested, but Congress refused to remove ceiling

Bills Only (2)

- Without Bills only, 4 ½ % ceiling could have been evaded by Fed-Treasury cooperation; Treas issues long at legal terms, sells issue to Fed at par via intermediary, Fed could sell long at market price, Fed records capital loss, transfers less to Treasury, consolidated Fed Treasury balance sheets as if Treasury sold long at market price [Friedman and Schwartz (1963), p. 636]
- 1960—Fed criticized for denying itself an independent policy instrument—to influence relative yields on long and short securities—Issue in 1960 Presidential election
- 1961—New Administration, Fed abandons Bills only
- Fed Operation Twist—Aims to keep T-bill rates high to retain gold, long-term rates low to stimulate domestic economic activity—Fed sells longs buys shorts without changing high-powered money
- Termination of Bills only ends self-imposed limit on independent fiscal policy initiative--management of debt maturity--unrelated to monetary policy
- Other self-imposed restrictions on independent action Fed has thought desirable: 1) Treasuries only, 2) Volcker priority for low inflation, 3) 2012 January 2% longer-run inflation objective...

Fed-Treasury Transfers and Surplus Capital

- 1913--Fed Res Act directs Fed retain net earnings to build its surplus capital equal to 40% of paid-in capital of member banks, then to transfer net earnings entirely to Treasury [Member banks required to subscribe (twice paid-in) capital to Res Bank capital equal to 6% their own capital; paid-in capital earns 6% fixed nominal interest]
- 1919—Congress allowed retained earnings to build surplus to subscribed capital, then to transfer 90% of net earnings to Treasury
- 1933—Banking Act abolishes transfers; created FDIC; Fed ordered to subscribe $\frac{1}{2}$ accumulated surplus in FDIC stock; Fed allowed to retain all subsequent net earnings to rebuild surplus; insignificant transfers until 1947
- 1947—As part of Accord, Fed Board voluntarily resumed Fed-Treasury transfers as “interest on Federal Reserve notes,” transferring 90% of net earnings to the Treasury; part of pre-Accord deal to float T-bill rate; **FED SURPLUS CAPITAL CONTINUES TO ACCUMULATE—BECOMES PROBLEM FOR THE FED**

Fed-Treasury Transfers and Surplus Capital (2)

- 1959—Federal budget deficit 3-times larger than any previous peacetime deficit
- Dec 1959—Appealing to 1919 Congressional action; Fed announced decision to transfer to Treasury 100% of net earnings after maintaining surplus at subscribed capital (twice paid-in) and to transfer excess immediately
- 1959to1964--Growth of member bank assets and liabilities yielded 35% increase in subscribed Fed capital; string of large peacetime Federal budget deficits
- Dec 1964 to Present—Fed announced voluntary 50% reduction in surplus to level of paid-in capital and would transfer 100% of net earnings after maintaining surplus at paid-in capital thereafter; paid \$524 million to Treasury in 1965 [Surplus history above is discussed in Goodfriend and Hargraves (1983)]

Fed-Treasury Transfers and Surplus Capital (3)

- 1993--Deficit Reduction Act contained provision to transfer \$213 million from Fed surplus account to help meet Federal budget targets in fiscal years 1997-98; Fed free to restore surplus to paid-in capital shortly after fiscal 1998 by withholding of transfers to Treasury
- 2000—Consolidated Appropriations Act directed Fed to transfer \$3.752 billion during fiscal 2000; again Fed permitted to retain earnings thereafter; Fed shortly thereafter restored surplus to paid-in capital by withholding transfers to Treasury

Fed-Treasury Transfers and Surplus Capital (4)

- 1996—GAO Report June, “Currently, and in the past, the levels of the surplus account have been discretionary because the requirement to have the surplus account equal to paid-in capital has been a matter of Federal Reserve policy; it was not required *by law* [italics added].” p. 67
- 1996—GAO Report June, “Congress may wish to determine whether these surplus accounts are necessary and, if so, set permanently *in law* [italics added] an appropriate amount for these accounts.” p. 68
- 2002—GAO Report Federal Reserve System: The Surplus Account, September, “The amount and timing of the Reserve Banks’ payments to the Treasury are not regulated by law. The Federal Reserve Board has discretion over the amounts the Federal Reserve System transfers to the Treasury.” p. 1

Fed-Treasury Transfers and Surplus Capital (5)

- 2002 GAO Report Federal Reserve System: The Surplus Account, September
- “*The Financial Accounting Manual for Federal Reserve Banks* says that the primary purpose of the surplus account is to provide capital to supplement paid-in capital for use in the event of loss. According to Board officials, the capital surplus reduces the probability that total Reserve Bank capital would be wiped out by a loss as a result of dollar appreciation, sales of Treasury securities below par value, losses associated with discount window lending...” p. 7
- “Federal Reserve Board officials noted, however, that it could be argued that any central bank, including the Federal Reserve System, may not need to hold capital to absorb losses, mainly because a central bank can create additional domestic currency to meet any obligation denominated in that currency.” p. 3

Fed-Treasury Transfers and Surplus Capital (6)

- 2002 GAO Report “On the other hand, it can also be argued that maintaining capital, including the surplus account, provides an assurance of a central bank’s strength and stability to investors and holders of its currency, including those abroad...The level of the Federal Reserve capital surplus account is not based on any quantitative assessment of potential financial risk associated with the Federal Reserve System’s assets or liabilities. According to Federal Reserve officials, the current policy of setting levels of surplus through a formula reduces the potential for any misperception that the surplus is manipulated to serve some ulterior purpose.” p. 3

Fed “Credit Policy” in the Crisis

- August 2007 and thereafter---Markets dump ABCP and other money market instruments; elevation of LIBOR as the liquidity squeeze spreads to depository sponsors of money market clients
- **FED CREDIT POLICY** re-intermediated short-term credit markets (including interbank markets) by selling Treasuries to entities no-longer willing to lend in money markets (including interbank markets) **AND** lending the proceeds to depositories no-longer able to borrow at reasonable rates in money markets; in part so depositories could finance their money market clients [**NOT MONETARY POLICY**]
- Sept 2008---With short interest at the zero bound, the Fed created reserves on a massive scale to fund i)money market credit facilities, ii)central bank swaps, iii)purchases of agency debt and MBS, and iv)acquisitions of long Treasuries

Fed “Credit Policy” in the Crisis (2)

- Monetary policy was used to finance credit policy in order to re-intermediate money market finance of longer-term cash flows
- Unlimited monetary finance for credit policy
- Fed used monetary and credit policy on scale hundreds of times greater than before
- Public recognized independent Fed wherewithal to stabilize the system

Fed “Credit Policy” in the Crisis (3)

- Fed willing to overshoot monetary and credit stimulus needed to stabilize financial markets and the macro-economy (shock and awe)
- Fed aware that recently authorized interest on reserves would enable it to raise interest against inflation if need be without first shrinking its balance sheet
- Credibility against deflation is tied to credibility against inflation
- Markets stabilized by spring 2009—Fed balance sheet stabilized, too

We Need an Accord for “Credit Policy”

- Fed was in no-win situation given wide powers to lend—disappoint expectations of accommodation and risk financial collapse, or take on underpriced credit risk with “implied promise of similar actions in times of future turmoil” (Volcker, NY Econ Club, April 8, 2008)
- Fed chose latter course in the Crisis
- Bagehot’s Rule followed by 19th century BofE: 1) banks needed currency to fund withdrawals 2) BofE need not take on credit risk to provide currency 3) BofE would “lend freely at a high rate on good collateral” without credit risk because private, profit maximizing 4) BofE had commitment mechanism to follow Bagehot’s Rule

We Need Accord for “Credit Policy”(2)

- Fed lacks commitment mechanism for Bagehot’s Rule
- Fiscal authorities receive net Fed income after expenses and taxpayers bear any Fed losses
- Hence, Fed inclined to take on under-priced credit risk when worried not doing so threatens a financial crisis
- Even when takes good collateral, Fed harms taxpayers if entity then fails, because then Fed takes collateral at expense of taxpayers exposed to losses from deposit insurance or other govt financial guarantees
- By protecting itself from ex post losses, Fed creates ex ante distortions by potentially delaying closure of insolvent entities

We Need Accord for “Credit Policy” (3)

- Fall 2008--Ambiguous boundary of responsibilities between Fed and fiscal authorities for credit/fiscal policy support of the financial system exacerbated Great Recession
- Accord for “Credit Policy” should circumscribe expansive, independent Fed credit initiatives
- Occasional Fed lending to solvent, supervised depositories, short term against good collateral is protected against ex post loss and ex ante distortion, so deserves a degree of operational independence
- 2010 Dodd-Frank Law recognizes the problem—requires Fed lending beyond depositories to be part of “broad program” approved by Treasury Secretary—still much scope for policymaker discretion

Fiscal Features of Monetary Policy and Credit Policy

- Fed employed expansive monetary and credit policies in 4 separate initiatives since markets stabilized in spring 2009
- QEs employ creation of bank reserves to finance credit policy acquisition of long MBS, and the acquisition of long Treasuries; Operation Twist was maturity extension of Treasuries
- QE 1—December 2008 to March 2010
- QE2—November 2010 to June 2011
- Operation Twist—Sept 2011 to Dec 2012
- QE 3—Sept 2012—open-ended and ongoing...\$85 billion per month reserve creation to acquire long Treasuries and MBS

Fiscal Features of Monetary Policy and Credit Policy (2)

- Balance Sheet policies work at zero interest bound by 1) taking credit risk onto the Fed balance sheet via MBS and by 2) taking interest rate risk onto the Fed balance sheet by financing acquisition of long bonds with bank reserve creation (QEs) or by selling short Treasuries (Op Twist)
- Credit policy works by compressing MBS/Treasury interest rate spreads to stimulate housing prices, production, sales
- Long bond finance with reserves (or shorts) works by compressing (or making negative) the term premium in bonds to encourage investment spending directly and by inducing investors to acquire riskier assets such as equities and real estate and encouraging spending indirectly through a wealth or credit channel
- Policies much less effective in recovery than in the crisis

Fiscal Features of Monetary Policy and Credit Policy (3)

- Fed balance sheet ~\$4 trillion and rising at \$85 billion a month with QE 3
- In order not to incur a fiscal cost, Fed must sell long securities for shorts or drain reserves and shrink its balance sheet *before* interest rates rise to fight inflation
- Otherwise, Fed must divert Fed-Treasury transfers to pay short market interest on bank reserves to “finance” holdings of long securities [\$2.6 trillion reserves]
- Alternatively, the Fed will realize capital loss if it were to sell longs *after* market interest rates rise
- Either way, those funds will be deducted from interest income the Fed would otherwise transfer to the fiscal authorities

Need Fed Independence to Pay Int on Reserves without Creating Reserves

FED BALANCE SHEET:

- 2007 June—20 billion reserves, .9 trillion currency, 32 billion paid-in capital plus surplus capital
- 2013 November—2.6 trillion reserves rising 85 billion per month with QE3, 1.4 trillion currency, 55 billion paid-in capital plus surplus capital
- Fed power to sustain its January 2012 announced 2% longer-run inflation objective requires independence to pay interest on reserves without creating reserves, if need be, to raise market interest rates without first shrinking the Fed balance sheet
- Fed credibility to anchor inflation expectations depends on its perceived independence to pay interest on reserves, if need be, to raise market interest rates against inflation

Need Fed Independence to Pay Int on Reserves without Creating Reserves (2)

- Negative cash flow problem could arise in exit from the zero bound. More likely if--
- Fed continues to expand purchase of long bonds (with reserves) at low long interest with ongoing QE3
- Fed must raise interest on reserves aggressively to fight inflation before can shrink Fed balance sheet
- Fed reluctant to realize capital losses on sales of long securities

Revisiting Fed-Treasury Transfers and Surplus Capital

- Reasons given in 2002 GAO Report for Fed formula transferring 100% net earnings to Treasury after maintaining surplus at paid-in capital are outdated:
- Greatly enlarged and still growing interest rate risk on Fed balance sheet
- January 2012 FOMC 2% longer-run inflation target
- Fed must be prepared to pay market rate on reserves to “finance” long-term assets
- Fed not free to “create additional domestic currency [ed., reserves] to meet any obligation denominated in that currency,” [ed., to create reserves to pay market interest on reserves in order to sustain 2% inflation

Revisiting Fed-Treasury Transfers and Surplus Capital (2)

- 2002 GAO Report: “The amount and timing of the Reserve Banks’ payments to the Treasury are not regulated *by law* [italics added]. The Federal Reserve Board has discretion over the amounts the Federal Reserve System transfers to the Treasury.” p. 1
- Congress has declined to set in law an appropriate rule for Fed-Treasury transfers and surplus capital
- Fed exposes taxpayers to significant fiscal risks without Congressional authorization

Revisiting Fed-Treasury Transfers and Surplus Capital (3)

- ACCOUNTING TREATMENT (2011)—If net Fed earnings insufficient to equate surplus to paid-in capital, after 6% dividends paid to member banks, Fed will “cover” the shortfall with a “negative liability account to the Treasury”
- Like “deferred asset,” recognition that Fed has future net earnings and independence to retain earnings to rebuild capital before remittances to Treasury resumed
- Future recapitalization; BUT DOES NOT enable Fed to finance interest on reserves without creating reserves
- Alternative—Treasury sells T-bills; deposits proceeds in Fed to extinguish its “neg liability account,” Fed buys T-bills with Treasury deposit; allows Fed to sell the T-bills to finance interest on reserves without creating reserves; amounts to an immediate recapitalization of Fed with T-bill transfers from Treasury

Revisiting Fed-Treasury Transfers and Surplus Capital (4)

- Deficiencies of Current Accounting Treatment:
- Allows independent Fed indefinitely to run up fiscal risks for taxpayers in an opaque manner
- Could be some time before Fed net earnings turn positive
- At best, retained earnings recapitalize Fed marketable securities gradually
- Consumer Financial Protection Bureau diverts future Fed earnings, leaving even less for Fed
- Fiscal authorities in future may legislate rules denying requisite withholding of Fed-Treasury transfers
- Does not solve the problem of capacity to pay interest on reserves without creating reserves

Revisiting Fed-Treasury Transfers and Surplus Capital (5)

- Economics of Fed Surplus:
- If Fed remits excess earnings to Treasury, then Treasury issues less new public debt to finance its deficit, saving interest cost
- If instead the Fed retains excess earnings to build up surplus capital by acquiring Treasury debt from the public, the Fed returns interest on that Treasury debt to the Treasury, and Treasury saves the same interest cost
- There is no fiscal cost to taxpayers or Treasury to the accumulation of surplus capital by the Fed

Revisiting Fed-Treasury Transfers and Surplus Capital (6)

- Federal Reserve Board officials agree, according to the 2002 GAO Report:
- “However, Federal Reserve Board officials told us that, because the maintenance of the capital surplus account is “costless” to the taxpayer and to the Treasury, the argument that a central bank does not need capital is not a rationale for reducing the surplus to any particular level, including zero.” pp. 5, 8; see also pp. 16-17 for an extended example

Revisiting Fed-Treasury Transfers and Surplus Capital (7)

- In practice, retaining Fed earnings to build surplus capital matters because:
- Retaining earnings forces the fiscal authorities to sell more public debt (unless they cut spending or raise taxes)
- Treasuries held by the Fed continue to count as publicly held debt
- Sales of additional public debt by the fiscal authorities use up debt capacity under the “federal debt ceiling”

Revisiting Fed-Treasury Transfers and Surplus Capital (8)

- The Fed should reach with Treasury an **“Accord on Transfers and Surplus”** to facilitate independence to act flexibly against inflation (or deflation) and sustain its 2% inflation objective—by providing precautionary marketable surplus capital to pay interest on reserves at market rates, if need be, to finance its holdings of long securities until the Fed can shrink its balance sheet
- Treasuries held by the Fed should be exempt from the debt ceiling
- Federal budget deficit should be reported properly to reflect economics of Fed-Treasury transfers and surplus
- The Fed and Treasury should agree on a rule for surplus capital to cover fiscal risks of independent Fed policies
- The Fed should retain earnings toward larger capitalization, supplemented with an immediate transfer of T-bills from Treasury to the Fed as appropriate

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