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Whom can we trust to run the Fed? Theoretical support for the founders' views

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Abstract

The Federal Reserve has been called a bizarre policymaking structure. This paper documents and formalizes a historical argument that the Fed's structure was a response to public conflict over inflation's redistributive powers. The paper shows that, in the face of conflict over redistributive inflation, policy by majority can lead to policy that is worse, even for the majority, than obvious alternatives. In balancing the interests for and against surprise inflation, the Fed's structure can lead to a better outcome.

Key words: Central bank design; Monetary policy; Voting

JEL classification: B25; E58; E61

1. Introduction

The Federal Reserve System has been called a 'peculiar', even a 'bizarre', governmental structure.¹ It is largely independent from direct government input, and power within the Fed is distributed among many people chosen in accordance with varied and elaborate rules. Now is a particularly interesting time to examine what the burgeoning theoretical literature on monetary policy formation says about the Fed's structure. The European Community is attempting to design a new central bank, and the U.S. Congress has recently considered bills to

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¹Kettl (1986), Melton (1985).

make the Fed more responsible to democratically elected officials. At the same time, many Western advisors are recommending more democratic governments but independent central banks for emerging market economies.

This paper shows that important features of the Fed can be rationalized in a simply motivated, historically grounded model of strategic policy. The theory is distilled from conventional views of the Fed's history and is motivated by evidence on the role inflation politics played in the U.S. prior to the Fed's founding. The basic argument is that in the face of conflict over redistributive inflation, monetary policy by majority might well lead to policy that is worse – even for the majority – than obvious alternatives. U.S. economic performance under the Articles of Confederation and during the free silver debates arguably illustrates this result. The Fed's structure, which emerged in legislation between 1913 and 1935, reflects the view that a better outcome will result from turning monetary policy over to a small group of people selected so as to balance the interests for and against inflation.

At the core of the analysis is a simple and generic point: the median voter's preferences may not reflect what is best for society. This is the same point exploited in Rogoff's (1985) argument that society might optimally choose a conservative central banker; Alesina and Grilli (1992) lay out similar reasoning in examining proposals for the European Central Bank.² Persson and Tabellini (1992) consider alike issues in the context of national capital tax rates.

This paper emphasizes two elements that are not standard in the literature. First, the source of inflationary bias is the heterogeneous preferences of the public. Most of the literature follows Barro and Gordon (1983) in which the bias arises from an exogenously specified preference for inflation surprises. This preference is rationalized in informal arguments. In this paper, the bias arises endogenously from the redistributive effects of inflation, and the historical importance of this source of bias is documented. Second, the paper highlights the internal structure of the central bank which, as Rogoff (1987) notes, is often ignored.³

Initially the paper reviews the historical literature, emphasizing the role redistributive inflation played in determining the Fed's structure. The historical argument is then formalized in the remainder of the paper.

2. The Fed's formation: A selective review

After the banking panic of 1907, most political and financial interests realized that some legislation would be enacted to provide an elastic currency. Although

²More generally, a number of papers have emphasized different aspects of the issue of heterogeneous policy preferences, e.g., Alesina (1987), Alesina and Tabellini (1987), Havrilesky (1987), Hibbs (1977, 1987).

³Waller (1992) is a notable exception.

this might have seemed a narrow, technical goal, conflict arose over who could be trusted to exercise the associated money creation powers. This issue was resolved over a 23-year period of legislation beginning with the Federal Reserve Act in 1913, including the Banking Act of 1933, and ending with the Banking Act of 1935, which brought the Fed essentially to its current form.

While the nature and extent of Federal Reserve independence has been much discussed, the Fed's unique internal power structure has received little attention. By the 1930s, it was clear that the power resided with the Federal Open Market Committee (FOMC), which is made up of the governors and the presidents of the Reserve Banks (Board of Governors, 1990). There are 12 votes on the FOMC: five presidents vote on a rotating basis, always including the president of the New York Fed and either the Chicago or Cleveland Fed president. The Reserve Bank presidents are nominated by the boards of their respective banks and confirmed by the Federal Reserve Board. The nominating boards are composed of nine directors, six chosen by district bankers (three representing district bankers and three representing general district interests), and three chosen by the Federal Reserve Board. The seven governors are nominated by the President of the U.S. with due regard to a fair representation of the financial, agricultural, industrial, and commercial interests. No two governors can come from one Federal Reserve district.

Obviously, the Fed's structure was designed to balance voting interests. The claim that inflation politics is crucial to understanding this structure is not novel. This section highlights the evidence for the view summarized by Kettl (1986, p. 42):

The Fed was born in controversy. Farmers and small businessmen wanted a decentralized organization under strong governmental control to counterbalance the power of eastern bankers. The financial community, on the other hand, feared that political control of the system would bring inflation.

2.1. Conflict between nominal debtors and creditors

Ignoring the internal structure of the Fed, it seems reasonable to suppose that the Fed was made independent to insulate policy from electoral manipulation. This danger was certainly understood by the framers. Such principal-agent issues between voters and the Federal government, however, cannot explain why the Fed was made largely independent not only of the political agents, but of their principals as well.⁴ Many framers were clearly concerned not only about principal-agent problems, but with the prospect that politicians would be *too* responsive to their principals. Their concerns were well founded.

⁴For example, Congress could have mandated great openness in monetary policymaking. In reality bankers got a direct channel for communication with the Board, the Federal Advisory Committee, but the public got none.

Populist demands for debt relief through surprise inflation or other means have deep roots in the U.S. Such demands following the Revolutionary War ‘threatened the existence of credit’ according to John Marshall (12 Wheat. 213, p. 354); James Madison (*The Federalist*, No. 44) cited this problem as the basis of the Constitution’s Article I, section 10 prohibition of bills of credit and of laws impairing the obligation of contracts. Populist inflation remained a political issue throughout the 1800s, but the free silver debates that reached peak intensity in the 1890s were most relevant to the Fed’s founding.⁵ Eastern creditors viewed with alarm Harvey’s (1963, p. 175) popular 1894 tract, which argued that by re-monetizing silver ‘[y]ou increase the value of all property by adding to the number of money units in the land. You make it possible for the debtor to pay his debts...’ Debtors in the West, for their part, saw the end of free coinage of silver as the *crime of ’73*, pushed through by the *money power*, selling out rural mortgage holders in order to push up asset values (e.g., Timberlake, 1978). While the pro-silver forces ultimately failed, Friedman and Schwarz (1963) argue that the fluctuating political prospects of the free silver forces led to large disruptions in international capital flows in the 1890s.

The desire to avoid a recurrence of such battles was clear in much of the debate surrounding the Fed’s founding. J. Laurence Laughlin (1933, p. 218), a noted monetary economist of the day, argued: ‘[P]oliticians find it easy to appeal to the underlying prejudice in favor of inflation in order to raise prices, or to lift the burden of debt.’ Senator Aldrich (Kettl, 1986, p. 21) contended: ‘No government has yet been found strong enough to resist the pressure for enlarged issue in times of real or imagined stress.’ Thus, many parties to the founding of the Fed argued that a ‘formula had to be found by means of which these two elements [big business and politicians] would be called upon to balance one another’ (Warburg, 1930, p. 773).

The struggle over this balance was perhaps most explicit in the 1935 debates regarding how to divide FOMC voting power between Reserve Bank presidents and the politically appointed governors. Henry Steagall sponsored the House Bill in which only the politically appointed Federal Reserve Board members would vote. Senator Glass responded that Steagall was without peer in his advocacy of inflation (Congressional Record, 1935, p. 11825). The ultimate voting balance adopted was summarized by Steagall (Congressional Record, 1935, p. 13706):

[U]nder the bill embodied in the conference report the board will stand 5 to 7 giving the people of the country, as contradistinguished from private banking interest, control by a vote of 7 to 5 instead of by a vote of 3 to 2 [as proposed in the Senate].

⁵See Friedman (1990) for a richer account of this period.

Some may find it difficult to reconcile the framer's fear of inflation with the fact that the U.S. was on the gold standard during much of the formative period. It is, however, easy to see why the gold standard was seen as an unreliable anchor. The U.S. was off the gold standard from the Civil War until 1879, and the free silver forces nearly took the U.S. effectively off again in the 1890s. The ratios of monetary gold to money and high powered money varied by a factor of two between 1879 and 1914 (Briggs et al., 1988). Foreign shipments of gold were suspended during World War I and convertibility was suspended outright in 1933. More importantly, perhaps, during the 1920s and early 1930s, when the FOMC was formulated, the desirability of the gold standard anchor was widely questioned, and many key players came to view monetary policy as a discretionary art.⁶

The remainder of the paper illustrates how the problem faced by the framers and the solution they chose arise naturally in monetary economies. While the modelling is, of necessity, less rich than that described in the historical evidence, three intuitively appealing features of the model drive the results: 1) Expected inflation is harmful – increases in steady-state inflation lower everyone's utility, 2) surprise inflation redistributes resources away from the nominally wealthy, and 3) the winners from surprise inflation outnumber the losers.

Given these three features, policy by majority is likely to, though does not necessarily, result in excessive inflation. The explanation for this parallels that given in the time consistency literature (e.g., Kydland and Prescott, 1977; Barro and Gordon, 1983). Although steady-state inflation is costly, the winners from surprise inflation – whom I call the working class – want to inflate away the wealth of the rich. They will do so whenever the marginal benefit from redistribution exceeds the marginal inflation cost. Everyone is aware of this, so the expected rate of inflation in equilibrium is the rate at which the marginal benefit from a surprise increase in inflation to the workers is just offset by the marginal cost. Because this inflation rate is fully expected, the workers get no benefit from redistribution, but everyone suffers the cost associated with equilibrium inflation. An *ad hoc* solution to the pro-inflation bias in this model is to hand policy over to a board with properly balanced interests.

3. The model

This section presents an overlapping generations model. I chose the overlapping generations framework because it is simple and well-studied, and most importantly, because it is one of the few well-known monetary models with heterogeneous agents and winners and losers from surprise inflation. The model has

⁶This view was by no means unanimous. For example, see Kettl (1986) on the debate between Henry Simon (rules) and Marriner Eccles (discretion).