

## THE EVOLUTION OF THE ROLE OF THE FEDERAL RESERVE

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What Causes Inflation?

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Chair Causer and members of the committee:

Thank you for this opportunity. My name is Carola Binder. I am an associate professor of economics at Haverford College and a visiting scholar at the Mercatus Center, and my research focuses on the Federal Reserve (Fed) and inflation.

Today I trace the evolving role of the Fed and highlight the following points:

1. The Fed was established in 1913 to promote financial stability. Until 1933, the United States was on the gold standard, which limited the monetary policy discretion of the early Fed.
2. The Fed gradually began using monetary policy to pursue the goals of full employment and price stability. These goals later became the Fed's formal mandate from Congress, but the Fed has considerable independence and discretion in how it prioritizes and pursues these goals
3. As the Fed has responded to the Great Recession and COVID-19 pandemic with a wider range of tools, it has relied on communication with the public to preserve its democratic legitimacy.

### MONEY AND BANKING BEFORE THE FEDERAL RESERVE

For most of US history before the Civil War, the country was on a metallic standard—the dollar was backed by a specific weight of gold, silver, or both. The Civil War prompted two major, highly contentious changes to the money and banking system. First, the legal tender acts of 1862 and 1863 authorized the Union government to issue unbacked paper currency, called greenbacks.<sup>1</sup>

Second, the national banking acts of 1863 and 1864 established a system of nationally chartered banks. The United States did not have a central bank, but the national banks were intended to facilitate the

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1. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton: Princeton University Press, 1963).

administration of a uniform national currency. The greenbacks and the national banking system were intended to help finance the war effort, but both remained in place when the war ended.

Some of the most contentious political debates of the postbellum era concerned money and banking. The Republican party tended to support a return to the gold standard, which they associated with “sound money” and less inflation. The United States did return to gold in 1879, though there was continued debate about expanding the currency with silver or paper money. Another feature of this period, known as the Gilded Age, was frequent banking panics.<sup>2</sup> A particularly severe panic in 1907 prompted Congress to establish the National Monetary Commission to study possible reforms to the nation’s money and banking system.

### **THE FEDERAL RESERVE AS A LENDER OF LAST RESORT**

Republican Senator Nelson Aldrich led the commission as it investigated the monetary and banking systems of European countries. Aldrich was impressed by how the central banks in Germany, France, and England promoted financial stability by serving as a “lender of last resort”—that is, by lending to commercial banks to help meet their liquidity needs. Aldrich proposed a privately owned, highly centralized “National Reserve Association of the United States” to serve as a central bank and lender of last resort. The Aldrich Plan was endorsed by the American Bankers Association and many Congressional Republicans, but it was opposed by Democrats and the newly elected President Woodrow Wilson when he took office in 1913.

The Federal Reserve Act of 1913 resulted from political compromises between those who preferred a centralized institution and those who were more skeptical of the concentration of financial power. The act established the Fed, consisting of a board of governors in Washington, DC, and 12 regional banks, each in charge of a geographic district. One of the regional Fed banks is in Philadelphia, and eastern Pennsylvania is in its district. The western part of Pennsylvania is in the Federal Reserve Bank of Cleveland’s district.

All nationally chartered banks were required to become members of the Fed, to hold stock at their regional Fed bank, and to be subject to Fed regulation. The primary role of the Fed would be to serve as a lender of last resort by lending to member banks. Note that the United States remained on the gold standard, so the Fed did not conduct monetary policy as Americans know it today. Instead, its intended aim was to manage the money supply to maintain the convertibility of the dollar to gold.

### **THE FEDERAL RESERVE IN WARTIME**

Shortly after the regional banks opened for business, World War I broke out in Europe. The Fed supported the Treasury in financing the war by, for example, helping to market Liberty Bonds to the public and Treasury bonds to commercial banks. After the war, the Fed gradually learned about new tools for influencing economic and credit conditions. Most important, Fed officials learned that by purchasing government securities, they could ease credit conditions, and by selling government securities, they could tighten credit conditions. The Fed began using this policy approach, called open

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2. Gary Richardson and Tim Sablik, “Banking Panics of the Gilded Age,” Federal Reserve History, December 4, 2015, <https://www.federalreservehistory.org/essays/banking-panics-of-the-gilded-age>.

market operations, to stabilize prices and moderate the business cycle, and the Federal Open Market Committee (FOMC) was later established to take on this policy role.<sup>3</sup>

Still, the role of the Fed in conducting monetary policy was constrained by the gold standard until 1933, when President Franklin D. Roosevelt took the United States off the gold standard as part of an effort to combat the Great Depression. In World War II, the Fed again supported the Treasury by keeping interest rates low, and price controls were used to combat inflationary pressures. After the war, the dollar was again linked to gold through the Bretton Woods agreement.

When the Korean War broke out, Fed officials were pressured to hold interest rates down to support the Treasury, as they had in the previous wars, but they realized that low interest rates were contributing to rising inflation. After much contention, in 1951, the Fed and the Treasury came to an agreement, known as the Treasury-Fed Accord, that allowed the Fed to conduct monetary policy to stabilize inflation with more independence from the Treasury.<sup>4</sup>

### THE GREAT INFLATION AND THE DUAL MANDATE

In the 1960s and 70s, policy mistakes contributed to rising inflation. In particular, policymakers believed in a “Phillips curve” tradeoff that would allow permanently lower rates of unemployment in exchange for modestly higher inflation. Thus, policymakers allowed overly expansionary monetary policy. As inflation eroded the value of the dollar, the United States could not maintain sufficient gold reserves to support the dollar’s convertibility, and President Richard Nixon closed the gold window, severing the link between the dollar and gold. Meanwhile, energy crises drove inflation even higher and increased unemployment.<sup>5</sup>

In 1978, with the Full Employment and Balanced Growth Act, also called the Humphrey–Hawkins Full Employment Act, Congress gave the Fed its “dual mandate” to pursue full employment and price stability. This seemed to put the Fed in an impossible position—tighter monetary policy would increase unemployment, which was already high, but looser monetary policy would increase inflation. Fed Chair Paul Volcker finally decided to prioritize fighting inflation, even if it meant a temporary recession.<sup>6</sup> The Volcker Fed succeeded in bringing inflation down, revealing the power of monetary policy and the importance of a central bank that is credibly committed to fighting inflation.

In the years that followed, the Fed continued to pursue its dual mandate through monetary policy conducted by the FOMC. The FOMC consists of seven members of the Board of Governors of the Federal Reserve System (including the Fed chair), the president of the Federal Reserve Bank of New York, and four of the other regional bank presidents on a rotating basis. The FOMC announces an increase in its target for an interest rate called the federal funds rate, which is the interest rate banks pay to borrow from other banks, when it wants to tighten monetary policy (to reduce inflation and employment); and it announces a reduction in its target when it wants to loosen monetary policy (to

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3. Friedman and Schwartz, *A Monetary History of the United States*.

4. Jessie Romero, “The Treasury-Fed Accord,” Federal Reserve History, November 22, 2013, <https://www.federalreservehistory.org/essays/treasury-fed-accord>.

5. Michael Bryan, “The Great Inflation,” Federal Reserve History, November 22, 2013, <https://www.federalreservehistory.org/essays/great-inflation>.

6. Allan H. Meltzer, *A History of the Federal Reserve*, vol. 2, bk. 2, 1970–1986 (Chicago: University of Chicago Press, 2009).

increase inflation and employment). To implement these changes in interest rates, the Board of Governors adjusts the interest rate it pays on banks' reserve balances.<sup>7</sup> The Fed also continues in its financial stability role, and it greatly expanded its emergency lending in the Great Recession and the COVID-19 recession.

The Fed, like many other central banks, has come to believe that greater transparency and communication with the public can improve its ability to stabilize the economy and improve its democratic legitimacy. In 2012, the FOMC announced that 2 percent inflation (as measured by the Personal Consumption Expenditures price index) was consistent with the price stability part of its mandate.<sup>8</sup> In 2020, this 2 percent inflation target was modified to an “average” inflation target, meaning that the Fed attempts to make up for past undershoots of inflation.<sup>9</sup>

As the economy recovered from the COVID-19 recession, the Fed prioritized the employment side of its dual mandate and allowed inflation to rise well above target. The FOMC has begun a cycle of federal funds rate increases aimed at reducing inflation. This monetary tightening will likely dampen consumer spending, investment, and employment. Monetary policymakers hope to engineer a soft landing—that is, a reduction in inflation without a major recession. This will be a difficult task.

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7. “FAQs: Interest on Reserves and the Implementation of Monetary Policy,” Federal Reserve Bank of New York, October 26, 2015, [https://www.newyorkfed.org/markets/ior\\_faq.html](https://www.newyorkfed.org/markets/ior_faq.html).

8. Board of Governors of the Federal Reserve System, “Federal Reserve Issues FOMC Statement of Longer-Run Goals and Policy Strategy,” press release, January 25, 2012, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm>.

9. “Guide to Changes in the 2020 Statement on Longer-Run Goals and Monetary Policy Strategy,” Board of Governors of the Federal Reserve System, last updated January 14, 2021, <https://www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm>.